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NAVAL POSTGRADUATE SCHOOL

MONTEREY, CALIFORNIA

MBA PROFESSIONAL REPORT

**Cost Analysis of Outsourcing
An Air Force Supply Squadron**

**By: Ryan J. Mahoney,
Scott D. Schofield**

December 2006

**Advisors: Douglas A. Brook,
Donald E. Summers**

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COST ANALYSIS OF OUTSOURCING AN AIR FORCE SQUADRON

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Submitted in partial fulfillment of the requirements for the degree of

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COST ANALYSIS OF OUTSOURCING AN AIR FORCE SUPPLY SQUADRON

ABSTRACT

Outsourcing is a commonly used method for providing cost savings in business and the Federal Government. This project begins by providing background on the history, goals, and problems associated with the A-76 process. It will then analyze the financial management aspects of the Air Force's 2001 decision to outsource one of its supply squadrons to determine whether anticipated cost savings were achieved. Any costs savings or increases will be analyzed to determine to what extent they exceeded expectations. If added costs came up throughout the life of the contract, the causes of these will be sought and determination made whether or not they could have been anticipated in the initial contract competition and used in the initial cost comparison.

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EXECUTIVE SUMMARY

Since the creation of more efficient organizations results in cost reductions, competitive sourcing is increasingly viewed as a way to reduce overhead costs and capture savings. This paper explains why outsourcing is used and provides an overview of the current process used to outsource government operations, which is outlined in the Office of Management and Budget A-76 Circular. It discusses the various risks associated with outsourcing and some of the problems with the cost estimates used by the government to determine cost savings. This paper discusses the FAIR Act and the President's Management Agenda and the impact that they have had on government outsourcing, problems the government has experienced in their outsourcing competitions, and proposed alternatives to the current A-76 process.

In addition, this paper examines an outsourcing of a supply squadron at an Air Force base. Data was collected and pre-outsourcing actual costs, estimated costs to keep the function in-house, anticipated contractual costs, and actual contractual costs were compared to determine if the anticipated cost savings were realized. Analysis of the outsourcing competition and the resulting contract was completed to determine if any deficiencies existed that may have contributed to the outcome.

The authors' findings are that outsourcing usually does create cost savings in the short run, although hidden and overlooked costs make these savings substantially lower than expected. Cost savings are less likely to exist in the long run. They also find that more consideration should be given to the risks of outsourcing before new competitions are begun.

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I. PROBLEM IDENTIFICATION

A. BACKGROUND

Outsourcing is a commonly used method for providing cost savings in business and the Federal Government. The current process for government outsourcing is outlined in the Office of Management and Budget (OMB) Circular A-76 and is commonly referred to as the A-76 process. In 2001, a particular Air Force Base, as part of a larger Air Force supply reconfiguration, completed the process for outsourcing the operations of the supply squadron. The contract that was let as part of this competition expired at the end of the 2005 fiscal year. With the entire life of the contract available for analysis, along with all of the material of the preceding A-76 process, an objective investigation can be made to determine whether the Air Force achieved the cost savings it anticipated.

B. PURPOSE

The purpose of this research is to analyze the financial management aspects of the Air Force's decision to outsource this particular supply squadron in order to determine whether cost savings were achieved. Any costs savings or increases will be analyzed to determine to what extent they exceeded expectations. If added costs came up throughout the life of the contract, the causes of these will be sought and determination made whether or not they could have been anticipated in the initial contract competition and used in the initial cost comparison. Furthermore, this research will lay a foundation for building a body of knowledge to be utilized for future research regarding the federal A-76 or competitive sourcing practices and procedures, from which conclusions about federal outsourcing can be drawn about the strengths and weaknesses of the procedures currently utilized.

C. SCOPE

This research will look at one particular outsourcing action that took place in the Air Force. The data provided includes documents from the pre-outsourcing period, the period of performance for the contract awarded, and historical data summarizing the period of time the contract was in effect. The particular supply squadron being analyzed should provide a fair representation of outsourcing actions accomplished by the Air Force

between 1998 and 2001. According to data provided to us by the particular base to which this squadron was assigned, it was one of 12 supply squadrons that underwent outsourcing actions via the A-76 guidelines between these years and was the third largest organization considered. This squadron was also competed later in the period (2001), along with three other squadrons, which should have provided the opportunity for lessons learned from previous competitions to be incorporated into a higher quality outcome than its predecessors.

D. RESEARCH QUESTION

Since the creation of more efficient organizations results in cost reductions¹, competitive sourcing is increasingly viewed as a way to reduce overhead costs and capture savings². Current literature states that these cost savings are often achieved regardless of whether the government or the commercial sector wins the competition³. This leads to the primary research question of: Did the outsourcing of a particular Air Force supply squadron's operations achieve the anticipated cost savings? Answering this question provides insight, after the full completion of a total outsourcing process, of the overall value of outsourcing activities within the federal government in order to maximize the effective use of limited tax dollars. More specifically, the answer to this question will be approached by looking at the actual costs incurred over the life of the outsourced contract and compared to the costs incurred prior to the outsourcing process. In addition, the actual costs incurred will be compared to the costs that may have been reasonably assumed to have been incurred if the contract was simply kept as-is and kept up with inflation during this period of time. Finally, a look at the estimated cost of the outsourced contract will be compared against the actual cost incurred over the period.

The primary research question will be approached by laying a foundation of the actions involved in the government outsourcing process, along with drawbacks and

¹ United States General Accounting Office. DOD Competitive Sourcing: Effects of A-76 Studies on Federal Employees' Employment, Pay, and Benefits Vary. Washington, D.C: U.S. General Accounting Office, 2001.

² Susan M. Gates and Albert A. Robbert. Personnel Savings in Competitively Sourced DoD Activities: Are they Real? Will they Last?. RAND, 2000.

³ United States General Accounting Office. DOD Competitive Sourcing: Savings are Occurring, but Actions are Needed to Improve Accuracy of Savings Estimates, 2000.

benefits of the process discovered by others. Next, an explanation of where and how data was obtained will be given in concert with how it will be analyzed to help draw conclusions for answering the research question. Actual analysis of the information and data will then occur and provide the basis for conclusions and recommendations for further study or inquiry.

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II. HISTORY AND ANALYSIS OF OUTSOURCING POLICY

A. INTRODUCTION

1. Overview of Outsourcing

At over \$2.7 trillion⁴, a one-percent reduction in costs would reduce the United States federal budget by over \$27 billion per year. To put this in context, these savings are roughly equal to the *combined* annual gross domestic products (GDPs) of North Korea and Mongolia⁵. To say the least, numbers of this magnitude provide a great opportunity for cost savings.

Outsourcing is one initiative used by the government to augment its capabilities and reduce its costs. Outsourcing is not a new idea. In fact, it has been around since the earliest days of our country when George Washington used contractors to support his troops during the American Revolutionary War⁶. Since then, the government has increasingly relied on the private sector to provide needed goods. Today the government produces very few of its own goods and relies almost exclusively on the private sector. However, it is only in the past half century that the government has made substantial efforts to outsource more of its service functions.

An official definition of outsourcing was provided in 1996 by the Defense Science Board's Task Force on Outsourcing and Privatization. They stated that:

Outsourcing often refers to the transfer of a support function traditionally performed by an in-house organization to an outside service provider. Outsourcing occurs in both public and private sectors. While the outsourcing firm or government organization continues to provide appropriate oversight, the vendor is typically granted a degree of flexibility regarding how the work is performed. In successful outsourcing arrangements, the vendor utilizes new technologies and

⁴ Office of Management and Budget. Budget of the United States Government Fiscal Year 2007, 2007.

⁵ CIA World Fact Book. "GDP 2003." 2003.
<http://www.theodora.com/wfb2003/rankings/gdp_2003_0.html>. Website last accessed August, 2006.

⁶ Michael R. Rampy. "Paradox Or Paradigm? Operational Contractor Support." Military Review. May-June (2005)

business practices to improve service delivery and/or reduce support costs. Vendors are usually selected as the result of competition among qualified bidders⁷.

In other words, outsourcing is a decision by the government to purchase goods and services from sources outside of the affected government agency⁸. At its core, outsourcing is a make-versus-buy decision. When the government is considering outsourcing a function, it engages in a process known as competitive sourcing. In this process, the government agency proposes a re-organization of its unit into a Most Efficient Organization (MEO). The proposed MEO then competes against other agencies and the private sector. If the MEO can provide the good or service at a lower cost than the private sector or another government agency, it retains the function in-house. If it cannot do so, the function is outsourced⁹.

2. Overview of OMB Circular A-76

The current process for competitive sourcing is outlined in the Office of Management and Budget (OMB) Circular A-76, which provides “an analytical framework on which the government bases a decision on who can best provide the products and services it needs”¹⁰.

The goals of the A-76 process are defined by the following three fundamental principles:

1. Achieve economy and enhance productivity;
2. Keep inherently governmental functions “in-house”;

⁷ United States Defense Science Board Task Force on Outsourcing and Privatization, and United States Office of the Under Secretary of Defense for Acquisition and Technology. Report of the Defense Science Board Task Force on Outsourcing and Privatization. Washington, D.C: Office of the Under Secretary of Defense for Acquisition and Technology, 1996.

⁸ Valerie Bailey Grasso. Defense Outsourcing: The OMB Circular A-76 Policy. Washington, D.C: Congressional Research Service, 2005.

⁹Thomas J. Moreau. The Evaluation of Appropriateness of OMB Circular A-76 Studies on Revenue-Generating Functions in Defense Working Capital Fund Activities. Naval Postgraduate School, 2002. Monterey, California.

¹⁰ T.F. Dedman. Memorandum for all Naval Postgraduate Civilian Employees: Commercial-Industrial Program Studies, 1979.

3. Rely on the commercial sector for products and services if determined economical¹¹.

Furthermore, the policy rests on four assumptions:

1. The federal government should not compete against its citizens, but rely on the commercial sector to supply products and services needed by the government;
2. The government can conduct cost comparison studies to determine “who best to do the work” through a process of “managed competitions”;
3. Market forces can determine the most effective and cost-efficient methods to operate functions in both government and commercial sectors;
4. The nature of competition within the marketplace can be “self-managed” and not require government oversight¹².

As was mentioned in the second A-76 fundamental principle, the government is required to keep inherently governmental functions in-house. It should be noted that there are multiple definitions of inherently governmental. The A-76 Circular defines an inherently governmental function as one that “requires either the exercise of substantial discretion in applying government authority or the making of value judgments in making decisions for the government”¹³.

Section 5 of P.L. 105-270, 31 U.S.C. 501 note (1998) defines an inherently governmental function as a “function that is so intimately related to the public interest as to require performance by Federal Government employees”¹⁴.

Regardless of the exact definition used, inherently governmental functions are not subject to outsourcing under the A-76 process.

3. History of A-76

Although outsourcing had been used by the federal government since its earliest days, it only began receiving significant attention in the mid-1950s when the Eisenhower

¹¹ Thomas J. Moreau. The Evaluation of Appropriateness of OMB Circular A-76 Studies on Revenue-Generating Functions in Defense Working Capital Fund Activities. Naval Postgraduate School, 2002. Monterey, California.

¹² Valerie Bailey Grasso. Defense Outsourcing: The OMB Circular A-76 Policy. Washington, D.C: Congressional Research Service, 2005.

¹³ Office of Management and Budget. Circular no. A-76, 1999.

¹⁴ 31 United States Code 501 Pub. L. 105-270. Federal Activities Inventory Reform, 1998.

administration encouraged federal agencies to obtain commercially available goods and services from the private sector whenever it was cost-effective¹⁵.

Eisenhower's direction led to the creation of the Commercial-Industrial Studies Program, which developed procedures and guidelines for outsourcing that would result in cost savings while still obtaining the correct support¹⁶. The resulting policy stated that "Federal agencies will not provide a function in-house that is obtainable from a private source unless Government performance of that function has been justified in the national interest"¹⁷.

In 1955, the predecessor to the A-76 Circular, Budget Bulletin 55-4, was issued. The Budget Bulletin stated, "It is the general policy of the Federal Government that it will not start or carry on any commercial activity to provide a service or product for its own use if such a product or service can be procured from private enterprise through ordinary business channels"¹⁸.

Budget Bulletin 55-4 was replaced by the OMB A-76 Circular in 1966. A year later, in 1967, the Circular underwent its first revision when formal guidelines for cost comparison procedures were added¹⁹. In 1979 the Circular was revised a second time to better define whether an agency had a requirement to contract out non-inherently governmental functions²⁰.

¹⁵ United States General Accounting Office. DOD Competitive Sourcing: Effects of A-76 Studies on Federal Employees' Employment, Pay, and Benefits Vary. Washington, D.C: U.S. General Accounting Office, 2001.

¹⁶ Thomas J. Moreau. The Evaluation of Appropriateness of OMB Circular A-76 Studies on Revenue-Generating Functions in Defense Working Capital Fund Activities. Naval Postgraduate School, 2002. Monterey, California.

¹⁷ T.F. Dedman. Memorandum for all Naval Postgraduate Civilian Employees: Commercial-Industrial Program Studies, 1979.

¹⁸ United States Department of Defense. Defense Reform Initiative Report, 1997.

¹⁹ Thomas J. Moreau. The Evaluation of Appropriateness of OMB Circular A-76 Studies on Revenue-Generating Functions in Defense Working Capital Fund Activities. Naval Postgraduate School, 2002. Monterey, California.

²⁰ Thomas J. Moreau. The Evaluation of Appropriateness of OMB Circular A-76 Studies on Revenue-Generating Functions in Defense Working Capital Fund Activities. Naval Postgraduate School, 2002. Monterey, California.

When President Reagan was elected to office, his administration emphasized the view that big government was inefficient, wasteful, and unmanageable²¹. In 1981 they directed a thorough analysis of the A-76 process, which took two years to complete. After the review was completed in 1983, OMB updated the Circular and set procedures in place to reestablish the initial objective of the Eisenhower administration. In particular, the revision clarified procedures and streamlined the evaluation process for outsourcing determinations²².

Administrative and legislative constraints from the late 1980s through the early 1990s resulted in a lull, and even a short moratorium, of outsourcing competitions²³. This began to change with the creation of the Clinton administration's National Performance Review (NPR) on 3 March 1993. The NPR focused on transitioning from a government that "works better and costs less" to a government that "works better and does less"²⁴, and promoted the idea that the government should focus its attention on those activities which it should and could do best and then place incentives in place to ensure optimum results²⁵. The recommendations of the NPR served as an impetus for the executive branch to propose new procurement reform in the following years²⁶.

In 1995, congressional and administration initiatives placed more emphasis on A-76 competitions as a means to achieve greater economies and efficiencies in operations²⁷. That same year, the Deputy Secretary of Defense directed the services to make

²¹ Valerie Bailey Grasso. Defense Outsourcing: The OMB Circular A-76 Policy. Washington, D.C: Congressional Research Service, 2005.

²² Thomas J. Moreau. The Evaluation of Appropriateness of OMB Circular A-76 Studies on Revenue-Generating Functions in Defense Working Capital Fund Activities. Naval Postgraduate School, 2002. Monterey, California.

²³ United States General Accounting Office. DOD Competitive Sourcing: Results of A-76 Studies Over the Past 5 Years: Report to Congressional Committees. Washington, D.C: U.S. General Accounting Office, 2000.

²⁴ Office of the Vice President. Serving the American Public: Best Practices in Downsizing, Benchmarking Study Report, 1997.

²⁵ Valerie Bailey Grasso. Defense Outsourcing: The OMB Circular A-76 Policy. Washington, D.C: Congressional Research Service, 2005.

²⁶ Office of the Vice President. From Red Tape to Results: Creating a Government that Works Better and Costs Less, 1998.

²⁷ United States General Accounting Office. DOD Competitive Sourcing: Results of A-76 Studies Over the Past 5 Years: Report to Congressional Committees. Washington, D.C: U.S. General Accounting Office, 2000.

outsourcing of support activities a priority, and the effort subsequently was incorporated as a major initiative under the Secretary's 1997 Defense Reform Initiative²⁸.

In 1996, the A-76 Circular underwent its fourth revision. The revision further clarified procedures for determining whether recurring commercial activities should be outsourced, balanced the interests of the parties in make-or-buy cost comparisons, provided a level playing field between public and private competitors, and encouraged competition and choice in the management and performance of commercial activities²⁹.

The Circular was revised a fifth time in 1999. This revision stated that the government may engage in inherently commercial activities if it can be determined that the function is critical to combat effectiveness or the mission effectiveness will suffer because of outsourcing, a commercial source is not available or cannot provide the product or service to meet government requirements in a timely manner, another Federal agency cannot provide the goods or services, or procuring from commercial firms will result in a higher cost to the government than if the item is produced internally³⁰.

The 1999 revision also implemented the statutory requirements of the Federal Activities Inventory Reform (FAIR) Act, which required that the head of each executive agency submit to the Director of OMB and Congress a list of activities performed by Federal Government sources for the executive agency, which in their opinion were not inherently governmental³¹. The FAIR Act will be discussed further in Section E of this chapter.

In 2001, President Bush's "President's Management Agenda" (PMA), which will also be discussed further in Section E of this chapter, identified competitive sourcing as one of five management initiatives designed to enhance government effectiveness³². It also led to another two-year study of the A-76 process.

²⁸ United States General Accounting Office. DOD Competitive Sourcing: Results of A-76 Studies Over the Past 5 Years: Report to Congressional Committees. Washington, D.C: U.S. General Accounting Office, 2000.

²⁹ Office of Management and Budget. Circular no. A-76: Performance of Commercial Activities, 1999.

³⁰ Office of Management and Budget. Circular no. A-76: Performance of Commercial Activities, 1999.

³¹ 31 United States Code 501 Pub. L. 105-270. Federal Activities Inventory Reform, 1998.

³² Office of Management and Budget. The President's Management Agenda for FY2002, 2001.

In 2003, the newest A-76 revision was completed. The revision did away with the two-step process in which industry first competes in a “best value competition” among other industry hopefuls, and then competes in a “cost comparison competition” with the government. Now there is a single competition, with the government MEO generally being treated as if it were another commercial bidder³³. The revision also added guidance governing conflicts of interest.

According to the Commercial Activities Panel, the group chiefly responsible for many of the recent changes, the “new Circular permits a greater reliance on procedures contained in the Federal Acquisition Regulations, and should result in a more transparent, simpler, and consistently applied process”³⁴. At this point, it is still too early to know what impact this newest revision will have on government outsourcing.

B. REASONS FOR OUTSOURCING

1. Introduction

To this point, we have discussed outsourcing and the A-76 process from the broad perspective of the government as a whole. Now we will narrow our focus to the Department of Defense (DoD). There have been many reasons offered for why the DoD is focusing so much of its attention towards outsourcing. In the end, they can be summed up into three reasons: move military members into warfighting positions, create more efficient and better performing organizations, and reduce costs.

2. Warfighting

The military services have been actively reviewing which military positions may be replaced by civilian or contractor personnel. By replacing military personnel with civilian or contractor personnel, especially in commercial-type functions, the services are able to reassign these personnel to operational areas where shortages of military

³³ Brett Stevens. *An Analysis of Industry's Perspective on the Recent Changes to Circular A-76*. Monterey, California: Graduate School of Business & Public Policy, Naval Postgraduate School, 2004. Monterey, California.

³⁴ United States General Accounting Office. *Competitive Sourcing: Implementation Will be Challenging for Federal Agencies*, 2003.

personnel exist³⁵. In other words, the services are trying to move as many military personnel as possible from support to warfighting roles.

The reason for this is simple. During the George H.W. Bush and Clinton administrations, the military was downsized by one-third³⁶. With current operations in Iraq and Afghanistan, and a sustained military presence in Korea and other locations around the globe, there is a shortage of military personnel.

Rather than rebuild the military to a level where it can execute the Global War on Terrorism by itself, the current Bush administration has decided instead to outsource many of the jobs that used to be performed by military personnel³⁷. For almost a decade, the military has been shifting supply and support personnel into combat jobs and hiring defense contractors to do the rest. As a result, the number of contract civilians performing work the military used to do has increased tenfold over this period³⁸.

The DoD's increased reliance on contractor support in part led to a 1997 report from the Government Accounting Office (GAO) which concluded that contractors have become a critical force multiplier in many missions because of troop ceilings, unavailable host-nation support, and the operational requirement to keep military units available to respond to major regional conflicts³⁹.

3. More Efficient and Better Performing Organizations

Many Americans view the culture of federal agencies as slow, conservative, adverse to risk, and resistant to change⁴⁰. Through the use of competitive sourcing, government agencies are compelled to identify the MEO capable of delivering the

³⁵ United States General Accounting Office, and United States. Dept. of Defense. Defense Management: DOD Faces Challenges Implementing its Core Competency Approach and A-76 Competitions. Washington, D.C: U.S. General Accounting Office, 2003.

³⁶ Leon Worden. "Downsizing and Outsourcing, We've Sprung Pandora's Box." The Signal June 27, 2004.

³⁷ Leon Worden. "Downsizing and Outsourcing, We've Sprung Pandora's Box." The Signal June 27, 2004.

³⁸ Michael R. Rampy. "Paradox Or Paradigm? Operational Contractor Support." Military Review. May-June (2005).

³⁹ United States General Accounting Office. Contingency Operations: Opportunities to Improve Logistics Civil Augmentation Program, 1997.

⁴⁰ Valerie Bailey Grasso. Defense Outsourcing: The OMB Circular A-76 Policy. Washington, D.C: Congressional Research Service, 2005.

required services⁴¹. This externally initiated self-evaluation forces the agencies to review their processes and increase their efficiency⁴². Some proponents of outsourcing claim that managed competitions not only increase efficiency, but also enhance quality, increase productivity, and spur on technological advances⁴³.

These views were supported in the President's 1999 budget, which stated that competition spurs efficiency. Agencies that require or provide administrative or other commercial support services should have the stimulus of competition to make available new technologies, capital, and new management techniques to improve performance and reduce costs⁴⁴.

Speaking at an outsourcing symposium in 1997, Dr. Paul Kaminski, the former Under Secretary of Defense for Acquisition and Technology, summed up the issue by stating:

If done correctly, competitive sourcing not only saves money, it helps the DoD to be an organization that thrives on competition, innovation, responsiveness to changing need, efficiency, and reliability⁴⁵.

Competitive sourcing forces many government organizations to take an inward look at themselves, which would not have occurred otherwise. In "Personnel Savings in Competitively Sourced DoD Activities" (2000), Susan Gates and Albert Robbert discussed why government managers rarely attempt to streamline their organizations without outside stimulus.

⁴¹ Chad M. Brooks, Edward J. White, and David E. Moore. Outsourcing Options to Meet Navy Recapitalization Goals. Naval Postgraduate School, 2004. Monterey, California.

⁴² Thomas J. Moreau. The Evaluation of Appropriateness of OMB Circular A-76 Studies on Revenue-Generating Functions in Defense Working Capital Fund Activities. Naval Postgraduate School, 2002. Monterey, California.

⁴³ Valerie Bailey Grasso. Defense Outsourcing: The OMB Circular A-76 Policy. Washington, D.C: Congressional Research Service, 2005.

⁴⁴ Valerie Bailey Grasso. Defense Outsourcing: The OMB Circular A-76 Policy. Washington, D.C: Congressional Research Service, 2005.

⁴⁵ Paul Kaminski. Remarks at Privatization and Outsourcing Symposium, Arlington VA, April 24, 1997.

In the private sector, managers face strong incentives to improve efficiency and effectiveness. The quality and cost of outputs are constantly monitored and managers are evaluated based these factors. Private sector managers are incentivized to make their organizations more efficient and effective.

Government managers, on the other hand, are often not evaluated on organizational outputs or outcomes because outcomes are too difficult to measure or because they depend on factors beyond the managers' control. In the instances when managers are judged on outcomes, it tends to be based on quality and not cost. With this incentive structure, managers tend to maximize the availability of resources, including human resources, required to produce quality outputs. Government managers are actually incentivized to *maximize* the size of their organizations⁴⁶.

By taking away the status quo as an option, the A-76 process is intended to make government organizations more effective and efficient by forcing managers to streamline their organizations.

4. Cost Reductions

Currently, about 60% of DoD's annual obligation authority is consumed by support infrastructure costs, of which personnel account for nearly half of the total⁴⁷. As can be imagined, these infrastructure costs are an enticing source of potentially large savings which could be used to finance weapons and equipment modernization⁴⁸ and quality of life improvements⁴⁹.

Since the creation of more efficient organizations results in cost reductions⁵⁰, competitive sourcing is increasingly viewed as a way to reduce overhead costs and

⁴⁶ Susan M. Gates, and Albert A. Robbert. Personnel Savings in Competitively Sourced DoD Activities: Are they Real? Will they Last?. RAND, 2000.

⁴⁷ Susan M. Gates, and Albert A. Robbert. Personnel Savings in Competitively Sourced DoD Activities: Are they Real? Will they Last?. RAND, 2000.

⁴⁸ Valerie Bailey Grasso. Defense Outsourcing: The OMB Circular A-76 Policy. Washington, D.C: Congressional Research Service, 2005.

⁴⁹ Susan M. Gates, and Albert A. Robbert. Personnel Savings in Competitively Sourced DoD Activities: Are they Real? Will they Last?. RAND, 2000.

⁵⁰ United States General Accounting Office. DOD Competitive Sourcing: Effects of A-76 Studies on Federal Employees' Employment, Pay, and Benefits Vary. Washington, D.C: U.S. General Accounting Office, 2001.

capture savings⁵¹. But cost savings are often achieved regardless of whether the government or the commercial sector wins the competition⁵².

DoD estimates claim that increased efficiencies resulting from competitions could yield 20-30% cost savings⁵³. In 1998, the DoD projected that these savings could amount to over \$6B by FY2003 and \$2.5B each year thereafter⁵⁴.

In 2003, OMB claimed that the DoD had achieved greater than 30% savings on the roughly 3,000 competitions it had conducted since 1979⁵⁵. A separate claim by the DoD stated that the Department had saved over \$1,478M, or 30%, in personnel costs alone on 2,138 A-76 studies completed between the years 1978 and 1996⁵⁶. While estimates of cost savings vary over time and between sources, most claim that the savings have been quite large.

5. Summary

Two logistics experts, LCDR Stephen Ferris and David Keithly summed up the reasons for outsourcing by concluding:

When judiciously exercised, outsourcing heightens performance, produces a streamlined workforce, and provides the best personnel. As a rule, specialization contributes to economies of scale and helps simplify organizational structures. Proper logistic outsourcing permits the armed services to focus on their respective core competencies. In short, outsourcing frees personnel to focus on what they do best⁵⁷.

⁵¹ Susan M. Gates, and Albert A. Robbert. Personnel Savings in Competitively Sourced DoD Activities: Are they Real? Will they Last?. RAND, 2000.

⁵² United States General Accounting Office. DOD Competitive Sourcing: Savings are Occurring, but Actions are Needed to Improve Accuracy of Savings Estimates, 2000.

⁵³ Valerie Bailey Grasso. Defense Outsourcing: The OMB Circular A-76 Policy. Washington, D.C: Congressional Research Service, 2005.

⁵⁴ David Warren. House National Security Subcommittee on Military Readiness, March 13, 1998.

⁵⁵ Office of Management and Budget. Competitive Sourcing: Conducting Public-Private Competition in a Reasoned and Responsible Manner. Washington, D.C.: Government Printing Office. July, 2003.

⁵⁶ Office of the Secretary of Defense. Improving the Combat Edge through Outsourcing. 1996.

⁵⁷ Stephen P. Ferris, and David M. Keithly. "Outsourcing the Sinews of War: Contractor Logistics." September-October (2001).

C. RISKS OF OUTSOURCING

1. Introduction

There are risks associated with outsourcing. These risks have led to the growing perception among some critics that outsourcing is not always to the government's advantage and that outsourcing may actually compromise the DoD's ability to accomplish its national security mission⁵⁸.

Risks are often the key determining factors in the success or failure of an outsourcing initiative⁵⁹. However, the A-76 process places such a strong emphasis on cost avoidance that few people would propose a more costly in-house alternative to outsourcing, even though it may provide a greater long-term strategic benefit to the organization⁶⁰. This has led to a process and mindset that focuses on outsourcing all commercial functions that can be performed more cheaply by the private sector, without giving much consideration to the associated risks.

One reason for this may be that the risks, and associated costs, are difficult to define and quantify, while the benefits of outsourcing, which are usually expressed as the relative cost reduction from outsourcing compared to in-house operations, are much more straightforward⁶¹.

Several costs, such as consultant fees and contract administration fees, are usually considered in the analysis. But other less-quantifiable costs are often ignored. These costs may include the long-run competitiveness of the agency if one or more of its core competencies are inadvertently outsourced, increased supplier power, the structural change of the value chain, and loss of strategic flexibility⁶².

⁵⁸ Brian Friel. "Depot Managers Protest Outsourcing." *Government Executive*. September 21, 1998.

⁵⁹ Chad M. Brooks, Edward J. White, and David E. Moore. *Outsourcing Options to Meet Navy Recapitalization Goals*. Naval Postgraduate School, 2004. Monterey, California.

⁶⁰ Christopher Lonsdale. "Outsourcing: A Business Guide to Risk Management Tools and Techniques." March (1998).

⁶¹ Chad M. Brooks, Edward J. White, and David E. Moore. *Outsourcing Options to Meet Navy Recapitalization Goals*. Naval Postgraduate School, 2004. Monterey, California.

⁶² Chad M. Brooks, Edward J. White, and David E. Moore. *Outsourcing Options to Meet Navy Recapitalization Goals*. Naval Postgraduate School, 2004. Monterey, California.

The simple fact is that bottom-line savings estimates often gold-plate, or cover up, outsourcing risks⁶³. This brings up an apparent dichotomy in the competitive sourcing process. The A-76 process is focused on cost savings, but only 5% of government agencies express their objectives in terms of short-term cost savings⁶⁴. For this reason, many experts believe that DoD should not focus on outsourcing as strictly a short-term cost cutting procedure, but as a mechanism that offers both improved efficiency and lower costs over the long run⁶⁵ and provides a long-term competitive advantage to the agency⁶⁶.

2. Types of Risk

The two major types of risk are strategic and operational⁶⁷.

a. Strategic Risks

Strategic risks are associated with the decision of whether or not to outsource a function. The three specific strategic risks are the outsourcing of core competencies, loss of flexibility, and opportunistic behavior.

(1) Outsourcing of Core Competencies. The DoD Senior Executive Council defines a military core competency as “a complex harmonization of individual technologies and production skills that create unique military capabilities valued by the force employing [commander in chief]”⁶⁸. According to the Council, a core competency has potential application to a wide variety of national security needs, provides a significant contribution to the combatant commander’s desired effect, would be difficult for competitors to imitate, provides the means to differentiate from

⁶³ Chad M. Brooks, Edward J. White, and David E. Moore. Outsourcing Options to Meet Navy Recapitalization Goals. Naval Postgraduate School, 2004. Monterey, California.

⁶⁴ Christopher Lonsdale. “Outsourcing: A Business Guide to Risk Management Tools and Techniques.” March (1998).

⁶⁵ Craig A. Powell. Transaction Cost Economics and A-76: A Framework for Defense Managers. Naval Postgraduate School, 2002. Monterey, California.

⁶⁶ Christopher Lonsdale. “Outsourcing: A Business Guide to Risk Management Tools and Techniques.” March (1998).

⁶⁷ Chad M. Brooks, Edward J. White, and David E. Moore. Outsourcing Options to Meet Navy Recapitalization Goals. Naval Postgraduate School, 2004. Monterey, California.

⁶⁸ United States General Accounting Office, and United States. Dept. of Defense. Defense Management: DOD Faces Challenges Implementing its Core Competency Approach and A-76 Competitions. Washington, D.C: U.S. General Accounting Office, 2003.

competitors, crosses organizational boundaries within an enterprise, is a direct contributor to the perceived value of the service, does not diminish with use, deploys with forces, and provides training and experience that forms the basis of ethos and culture⁶⁹.

Because they are uniquely military in nature and of vital importance to national security, the DoD's core competencies should not be outsourced. However, the A-76 process does not consider core competencies in its analysis. It instead focuses on whether a function is inherently governmental. The important thing to consider is that while the concepts of "inherently governmental" and "core" are similar and may overlap, they may not always be the same. Specifically, not all inherently governmental functions would be considered core, and not all core functions would be considered inherently governmental⁷⁰.

During the competitive sourcing process, DoD agencies should conduct strategic assessments to identify their core competencies and ensure that they maintain control of them so they can continue to meet future mission requirements.

(2) Loss of Flexibility. DoD agencies should consider their strategic flexibility during the competitive sourcing process. If considered independently of one another, each function could be outsourced to a different organization, public or private, that specializes in that function. Doing this would increase the efficiency of each function, but would eliminate the possibility of a system-wide innovation. Instead of looking only at the incremental benefits of outsourcing each individual function, agencies should complete a comprehensive strategic evaluation of all past and current outsourcing initiatives and consider them as a whole⁷¹.

If an agency fails to do this and outsources its functions to too many different organizations, the opportunities for cross-functional communication and

⁶⁹ United States General Accounting Office, and United States. Dept. of Defense. Defense Management: DOD Faces Challenges Implementing its Core Competency Approach and A-76 Competitions. Washington, D.C: U.S. General Accounting Office, 2003.

⁷⁰ United States General Accounting Office, and United States. Dept. of Defense. Defense Management: DOD Faces Challenges Implementing its Core Competency Approach and A-76 Competitions. Washington, D.C: U.S. General Accounting Office, 2003.

⁷¹ Chad M. Brooks, Edward J. White, and David E. Moore. Outsourcing Options to Meet Navy Recapitalization Goals. Naval Postgraduate School, 2004. Monterey, California.

synergy are lost⁷². The resulting effort required to coordinate all of the different functions across the inefficient array of independent suppliers could easily outweigh any benefits.

(3) Opportunistic Behavior. DoD agencies should also consider the impacts of their outsourcing decision on the entire value chain. Once a function is outsourced, the agency effectively removes itself as a supplier of that function⁷³. The result could be a de facto value chain integration that could place control of the function in the hands of only a few suppliers, who could then use their newfound power to engage in opportunistic behavior and dictate unfavorable terms to the agency.

Opportunistic behavior, which is defined as “self-interest seeking with guile”, can manifest itself in different ways. Firms can exercise opportunistic behavior by strictly following contracts and only performing functions explicitly listed in the contract, or by reacting slowly to a crisis and using this as an opportunity to seek additional compensation⁷⁴.

Opportunistic behavior is most likely to occur if the agency is bound in a contract and is unable to use alternate suppliers, if the agency becomes extremely reliant on the supplier, or if the function is so important that the agency cannot afford any interruptions in service⁷⁵. Agencies should carefully consider the likelihood and implications of opportunistic behavior during the competitive sourcing process.

b. Operational Risks

Operational risks are not associated with the decision of whether to outsource a function, but rather the decision of *how* the function will be outsourced⁷⁶. These risks include the packaging of requirements; an incomplete Statement of Work

⁷² Chad M. Brooks, Edward J. White, and David E. Moore. Outsourcing Options to Meet Navy Recapitalization Goals. Naval Postgraduate School, 2004. Monterey, California.

⁷³ Chad M. Brooks, Edward J. White, and David E. Moore. Outsourcing Options to Meet Navy Recapitalization Goals. Naval Postgraduate School, 2004. Monterey, California.

⁷⁴ Craig A. Powell. Transaction Cost Economics and A-76: A Framework for Defense Managers. Naval Postgraduate School, 2002. Monterey, California.

⁷⁵ Craig A. Powell. Transaction Cost Economics and A-76: A Framework for Defense Managers. Naval Postgraduate School, 2002. Monterey, California.

⁷⁶ Chad M. Brooks, Edward J. White, and David E. Moore. Outsourcing Options to Meet Navy Recapitalization Goals. Naval Postgraduate School, 2004. Monterey, California.

(SOW), Performance Work Statement (PWS), or Quality Assurance Surveillance Plan (QASP); the quality and type of contract; and insufficient resources to manage the contract.

(1) Packaging of Requirements. During the “packaging” stage of the A-76 process, the agencies identify the commercial activities within their organizations that are to be studied⁷⁷. It is important that the managers within the agency understand how to properly bundle or unbundle the activities being outsourced⁷⁸. While this may sound obvious, this initial stage will have a large impact in determining whether the outsourcing initiative will be successful.

If several functions are included in the package, fewer contractors will be able to compete for the contract and the agency could become vulnerable to opportunistic behavior. At the same time, unbundling too many functions could lead to an excessive number of contractors and higher coordination costs⁷⁹. Unfortunately, finding the optimal middle ground between these two extremes is both subjective and difficult.

(2) Insufficient SOW/PWS/QASP. It is very important for agencies to devote the time and effort necessary to adequately define the requirements being outsourced and develop high-quality outsourcing documents. Failure to do so will often result in ineffective or incomplete SOW’s and PWS’s. These poor-quality documents can lead the agency to purchase goods and services that are not really needed or, more commonly, under-define their requirements and then execute costly modifications to expand the contract.

⁷⁷ Craig A. Powell. Transaction Cost Economics and A-76: A Framework for Defense Managers. Naval Postgraduate School, 2002. Monterey, California.

⁷⁸ Craig A. Powell. Transaction Cost Economics and A-76: A Framework for Defense Managers. Naval Postgraduate School, 2002. Monterey, California.

⁷⁹ Craig A. Powell. Transaction Cost Economics and A-76: A Framework for Defense Managers. Naval Postgraduate School, 2002. Monterey, California.

Furthermore, an effective PWS and QASP will help to identify areas in which the contractors can exhibit opportunistic behavior⁸⁰, enabling the government to take proactive steps to minimize the likelihood and impact of these behaviors.

(3) Quality and Type of Contract. Inappropriate or poorly written contracts can expose the agency to a high risk of interrupted service, poor quality, and cost growth⁸¹. To minimize these risks, contracts should clearly state service levels and measurements, penalties for non-performance, growth and inflation rates, and termination provisions⁸². If applicable, they should also address potential contingency situations to eliminate the costly and time-consuming contract modifications that would result if the contingency were to occur.

The contract should also consider the incentives implicit in the various contract types and then pick the one that is best suited for the function being outsourced⁸³. For example, a fixed-price contract is often the best option for a well-defined, routine, or recurring service such as janitorial or lawn maintenance. However, it is usually not appropriate for complex services because it does not provide the flexibility, incentives, and governance mechanisms needed to achieve cost savings⁸⁴. For complex services, such as Research and Development (R&D), a cost-type contract is usually the best option.

(4) Length of Contract. The contract length is an important factor in the success or failure of the outsourcing initiative. In dealing with long-term contracts, it is nearly impossible to anticipate how the future will unfold because, as time passes,

⁸⁰ Craig A. Powell. Transaction Cost Economics and A-76: A Framework for Defense Managers. Naval Postgraduate School, 2002. Monterey, California.

⁸¹ Chad M. Brooks, Edward J. White, and David E. Moore. Outsourcing Options to Meet Navy Recapitalization Goals. Naval Postgraduate School, 2004. Monterey, California.

⁸² Christopher Lonsdale. "Outsourcing: A Business Guide to Risk Management Tools and Techniques." March (1998).

⁸³ Chad M. Brooks, Edward J. White, and David E. Moore. Outsourcing Options to Meet Navy Recapitalization Goals. Naval Postgraduate School, 2004. Monterey, California.

⁸⁴ Craig A. Powell. Transaction Cost Economics and A-76: A Framework for Defense Managers. Naval Postgraduate School, 2002. Monterey, California.

the market will likely change or evolve in unforeseen ways⁸⁵. Many estimates, including growth and inflation, become less reliable with time⁸⁶ and new technologies may drastically change the way the work is performed. The agency's mission could also change, requiring either more or less contractor support. However, long-term contracts commit the agency to its current decision even though these, and other, factors may change significantly during the execution of the contract⁸⁷.

Long-term contracts can also transfer a great deal of power to the contractor and allow for opportunistic behavior unless the forces of the competitive market can be reintroduced during the contract period⁸⁸. To be fair, there are also high costs associated with short-term contracts. Not only would additional resources be required to conduct the outsourcing initiative more frequently, but contractor prices would also be higher because of startup costs, fixed costs, and a higher contractor risk resulting from a reduction in job stability. The mission of the unit may also suffer if there is constant turmoil from frequent contractor turnover.

One compromise is a base contract with option periods that enable both the firm and supplier to review the relationship periodically and consider other alternatives⁸⁹. However, even this arrangement is not perfect and outsourcing agencies should ensure they weigh any cost-savings from long-term contracts against their inherent loss of flexibility. In the end, choosing the correct contract length is a very subjective decision that must be accomplished on a case-by-case basis.

(5) Insufficient Resources to Manage Contract. After a function is outsourced, the agency needs to ensure that it allocates sufficient resources to manage the contract effectively. Although these resources should have been included in the sourcing

⁸⁵ Craig A. Powell. Transaction Cost Economics and A-76: A Framework for Defense Managers. Naval Postgraduate School, 2002. Monterey, California.

⁸⁶ Chad M. Brooks, Edward J. White, and David E. Moore. Outsourcing Options to Meet Navy Recapitalization Goals. Naval Postgraduate School, 2004. Monterey, California.

⁸⁷ Chad M. Brooks, Edward J. White, and David E. Moore. Outsourcing Options to Meet Navy Recapitalization Goals. Naval Postgraduate School, 2004. Monterey, California.

⁸⁸ Craig A. Powell. Transaction Cost Economics and A-76: A Framework for Defense Managers. Naval Postgraduate School, 2002. Monterey, California.

⁸⁹ Chad M. Brooks, Edward J. White, and David E. Moore. Outsourcing Options to Meet Navy Recapitalization Goals. Naval Postgraduate School, 2004. Monterey, California.

decision, they can sometimes be reduced or re-distributed as budgets shrink and leadership is replaced. If this occurs, poor performance and rising costs are likely to occur. If the function being performed is a core or near-core competency, the results can be particularly disastrous⁹⁰.

3. How to Determine Contract Risk

Now that we have discussed some of the major *types* of risk associated with outsourcing, we will focus our efforts on how to determine the *level* of those risks. In his thesis titled “Transaction Cost Economics and A-76: Framework for Defense Managers,” Craig Powell talked at length about the field of Transaction Cost Economics (TCE) and how it can be used to determine and minimize contract risk. The three risk factors he considered were asset specificity, complexity, and frequency.

Powell defined risk in terms of colored lights. A Red Light represents high risk, a Yellow Light represents medium risk, and a Green Light represents low risk. He stated that the color of the light can be determined by the managers and contracting officers asking the following questions:

- How many firms can perform this function?
- What is the composition and degree of asset specificity involved?
- What are the opportunities for holdup?
- What is a reasonable contract period that will allow the government the ability to renegotiate or re-compete if necessary?
- What incentives and award fees are necessary to ensure contractor compliance that could also be used to reward outstanding performance⁹¹?

a. Asset Specificity

There are six commonly accepted categories of asset specificity in TCE:

- Physical Asset Specificity refers to an asset or piece of equipment that is required to produce a particular product;
- Human Asset Specificity is the knowledge and skills that individuals acquire while working for an organization;

⁹⁰ Chad M. Brooks, Edward J. White, and David E. Moore. Outsourcing Options to Meet Navy Recapitalization Goals. Naval Postgraduate School, 2004. Monterey, California.

⁹¹ Craig A. Powell. Transaction Cost Economics and A-76: A Framework for Defense Managers. Naval Postgraduate School, 2002. Monterey, California.

- Site Specificity refers to assets that are bound together by location in order to produce a product;
- Dedicated Asset Specificity includes items that are required to manufacture a product for a particular buyer;
- Brand-name Asset Specificity exists where investments made by one party are affected by the reputations or actions of other firms, such as franchises;
- Temporal Asset Specificity refers to investments in time-critical areas or bottleneck activities that have a great impact on delivery schedule and costs⁹².

The basic premise of asset specificity is that highly specialized functions tend to have greater risk and higher costs. Transactions that involve a greater degree of asset specificity, higher uncertainty, and are not frequently conducted tend to require more complex contracts and more explicit monitoring of the contracts⁹³.

Red Lights exist when physical asset specificity is high, there are few other firms, the tasks to be performed are highly specific, and the threat of opportunistic behavior is high⁹⁴. Opportunistic behavior is likely to occur whenever a contractor is asked to invest in specific assets. Because the government usually directly or indirectly pays for specific assets in the contract, it is more inclined to remain in an agreement with the current contractor who has already invested in the assets, rather than start again with a new contractor. An example of this would be the design and procurement of a new aircraft. The chance of opportunistic behavior increases even further if the requirement is highly specific in nature and the contractor is the only supplier that can perform the function⁹⁵.

In a Red Light situation, the contract should be well specified with a detailed cost structure that offers incentives and award fees to reward outstanding service. Substandard performance should be clearly delineated in the contract and should result in

⁹² Francois Melese, and Raymond E. Franck Jr. "Government Outsourcing: An Application and Synthesis of Transaction Cost Economics with a Stylized Bargaining Game." (2002).

⁹³ Craig A. Powell. Transaction Cost Economics and A-76: A Framework for Defense Managers. Naval Postgraduate School, 2002. Monterey, California.

⁹⁴ Craig A. Powell. Transaction Cost Economics and A-76: A Framework for Defense Managers. Naval Postgraduate School, 2002. Monterey, California.

⁹⁵ Craig A. Powell. Transaction Cost Economics and A-76: A Framework for Defense Managers. Naval Postgraduate School, 2002. Monterey, California.

the loss of incentive and award fees⁹⁶. Fixed-price contracts, with their limited cost flexibility, increase the probability of opportunistic behavior occurring.

b. Complexity

In general, the more complex a transaction, the more difficult it is to realize cost savings through outsourcing⁹⁷. Complex, or Red Light, transactions, such as R&D, require very long and detailed contracts. Since so many factors and intricacies need to be included, writing a “complete contract” that includes every detail, considers every contingency, and minimizes opportunistic behavior is extremely difficult. The outsourcing of complex requirements often results in cost overruns.

c. Frequency

Red Light functions must be performed quickly on a frequent basis⁹⁸. An example would be the monitoring and maintenance of a computer network in a Network Operations Security Center (NOSC). Because of the constant supervision required, the costs associated with administering this type of contract are significant. Furthermore, if the requirement is for a core or near-core competency and the contractor fails to perform the function in a timely manner, the impact to mission readiness could be devastating. In this situation, the agency should choose a cost contract with clear guidelines for minimum acceptable performance and incentives for outstanding performance⁹⁹.

4. Different Goals from Participants

A consideration that is often overlooked is that each member of the government outsourcing team has different, and often contradictory, goals. The end user, or customer, wants to get the highest level of service. Financial managers and comptrollers

⁹⁶ Craig A. Powell. Transaction Cost Economics and A-76: A Framework for Defense Managers. Naval Postgraduate School, 2002. Monterey, California.

⁹⁷ Craig A. Powell. Transaction Cost Economics and A-76: A Framework for Defense Managers. Naval Postgraduate School, 2002. Monterey, California.

⁹⁸ Craig A. Powell. Transaction Cost Economics and A-76: A Framework for Defense Managers. Naval Postgraduate School, 2002. Monterey, California.

⁹⁹ Craig A. Powell. Transaction Cost Economics and A-76: A Framework for Defense Managers. Naval Postgraduate School, 2002. Monterey, California.

are concerned with the bottom line, and focus their attention on cost savings. Contracting officers want to write an adequate contract and adhere to regulations¹⁰⁰.

On the other side of the fence, the contractor is trying to perform an adequate level of service and maximize its profit. If the government team cannot compromise and work together to provide the end user with good service at a low cost while following all of the regulations, the infighting amongst the members may allow the contractor to take advantage of the situation.

5. Conclusion

The various risks mentioned previously can negatively impact the agency in many ways. There is often cost growth associated with poorly defined requirements and opportunistic behavior. There is also a loss of flexibility when a function is outsourced because when military and government civilian personnel are replaced with contractor personnel, commanders no longer have the authority to adjust schedules or requirements unless those changes are specifically addressed in the contract¹⁰¹. Of course, any changes outside of the contract will contribute to cost growth.

While cost growth and the loss of flexibility are arguably the most visible negative impacts of outsourcing, they are certainly not the only ones. Some critics believe that:

- Safety may be compromised since private contractors do not subject their workers to the same level of educational and training requirements as federal workers;
- The threat of strikes and work stoppages, prohibited to federal workers, could damage the military's operational capabilities;
- Federal workers take oaths to uphold the national interest, while private contractors do not;
- Costs and efficiency will govern contractor business decisions, potentially replacing loyal, experienced, and higher paid federal workers with disloyal, inexperienced, and lesser-paid contract workers¹⁰².

¹⁰⁰ Craig A. Powell. Transaction Cost Economics and A-76: A Framework for Defense Managers. Naval Postgraduate School, 2002. Monterey, California.

¹⁰¹ Craig A. Powell. Transaction Cost Economics and A-76: A Framework for Defense Managers. Naval Postgraduate School, 2002. Monterey, California.

¹⁰² "Navy to Seek Private Bids for Weapons Handling." Los Angeles Times. March 13, 1999.

In an article about operational contractor support, Colonel Michael Rampy, United States Army (Ret.), Ph.D., gave the following prediction:

System support contractors primarily sustain individual systems and equipment... These contractors perform specific and precisely defined activities that are essential to operating modern military systems. As weapons and technological systems become increasingly sophisticated and integral to operations at all levels of war, the need for technical expertise in the 21st century battlespace has never been greater. With the introduction of increasingly sophisticated weaponry and technologically advanced systems, a revolution in military affairs assures that system support contractors will become increasingly crucial components of successful mission accomplishment¹⁰³.

As we head into a time of increasing reliance on contractor support, we need to remember, and consider, all of the risks associated with outsourcing.

D. PROBLEMS WITH COST ESTIMATES

1. Introduction

The Committee harbors serious concerns about the current DoD outsourcing and privatization effort. While the Committee recognizes the need to reduce DoD infrastructure costs, the cost savings benefits from the current outsourcing and privatization effort are, at best, debatable. Despite end-strength savings, there is no clear evidence that this effort is reducing the cost of support function within DoD with high cost contractors simply replacing government employees¹⁰⁴.

- Final report of the House Appropriations Committee, 1999

We discussed the large estimated cost savings that DoD realizes through outsourcing. However, many experts, including the House Appropriations Committee, believe that these estimates are overstated.

2. Reasons for Overstated Cost Savings Estimates

In this subsection, we will discuss seven reasons why the DoD may overestimate its cost savings from outsourcing. They include: inadequate records, acquisition and investment costs, transfers of costs, forced labor rates, imprecise cost factors, costs of personnel reductions, and cancelled competitions.

¹⁰³ Michael R. Rampy. "Paradox Or Paradigm? Operational Contractor Support." *Military Review*. May-June (2005).

¹⁰⁴ House Appropriations Committee. House Appropriations Committee Report 106-244, 106th Congress, 1st Session, 1999.

a. Inadequate Records

DoD has had difficulty identifying and assessing current costs because many agencies do not maintain adequate financial records of work performed in-house¹⁰⁵. The financial data used to calculate current costs, as well as resulting cost savings, is stored in the Commercial Activities Management Information System (CAMIS) database. Among other things, each DoD component is required to enter the original manpower baseline cost of the function being outsourced, the estimated cost savings of the competition, and the actual costs for the first five years after the competition is completed¹⁰⁶.

GAO has reported concerns about the accuracy and completeness of data contained in CAMIS¹⁰⁷. As early as 1990, GAO stated that CAMIS contained inaccurate and incomplete data¹⁰⁸. In a 1996 report, the Center for Naval Analyses also found that the data in CAMIS was incomplete and inconsistent among the services and recommended that the data collection process be more tightly controlled so that data would be consistently recorded¹⁰⁹. In 2000, GAO again reported deficiencies in the CAMIS database¹¹⁰.

GAO found that data, once entered into CAMIS, was often not modified to reflect changes in, or even termination of, contracts. Some competitions were recorded as completed even though they were still underway or had not yet begun. In some cases data was not adjusted and removed from the system even when bases were closed or realigned. In addition, GAO found that CAMIS did not accurately track baseline costs or

¹⁰⁵ Chad M. Brooks, Edward J. White, and David E. Moore. Outsourcing Options to Meet Navy Recapitalization Goals. Naval Postgraduate School, 2004. Monterey, California.

¹⁰⁶ United States General Accounting Office. DOD Competitive Sourcing: Results of A-76 Studies Over the Past 5 Years: Report to Congressional Committees. Washington, D.C: U.S. General Accounting Office, 2000.

¹⁰⁷ United States General Accounting Office. DOD Competitive Sourcing: Results of A-76 Studies Over the Past 5 Years: Report to Congressional Committees. Washington, D.C: U.S. General Accounting Office, 2000.

¹⁰⁸ United States General Accounting Office. OMB Circular A-76: DOD's Reported Savings Figures are Incomplete and Inaccurate. Vol. GAO/GGD-90-58, March. 15, 1990.

¹⁰⁹ Center for Naval Analyses. An Examination of the DOD Commercial Activities Competition Data. Vol. CIM 472, December 1996.

¹¹⁰ United States General Accounting Office. DOD Competitive Sourcing: Savings are Occurring, but Actions are Needed to Improve Accuracy of Savings Estimates, 2000.

reasons for contract changes, and did not contain accurate and complete data on items such as program implementation or contract administration costs¹¹¹. All of these factors combine to make it very difficult to develop accurate baseline cost estimates and track cost savings.

b. Acquisition and Investment Costs

The DoD does not always consider all of the investment costs associated with performing the competitive sourcing analysis and transitioning to either the MEO or contractor performance. The total sourcing costs often include:

- Training of government personnel involved in the A-76 process;
- Production of study documents (PWS, MEO, etc) by government employees with contractor support;
- Source selection and evaluation board costs, to include the salary of government employees evaluating contractor and government proposals;
- Independent review of government documents;
- Lost productivity and redistribution of work normally done by employees directly or indirectly involved in the study;
- Transition costs, such as employee workshops, job fairs, additional administrative support to affected employees, management of potentially adverse employee impacts, and transition training;
- Contractor phase-in and overlapped expenses associated with loss of government workers prior to contract start date;
- Voluntary separation incentive payments to reduce effects of reductions in force;
- Severance pay;
- Priority placement program entitlement expenses for displaced employees gaining employment outside the commuting area¹¹².

¹¹¹ United States General Accounting Office. DOD Competitive Sourcing: Results of A-76 Studies Over the Past 5 Years: Report to Congressional Committees. Washington, D.C: U.S. General Accounting Office, 2000.

¹¹² Charles H. Fritz. Dollars and Sense: DoD's A-76 Dilemma. National Defense University, National War College: 2001.

In FY 2004, DoD estimated that the acquisition and investment costs total \$3,000 for each position outsourced¹¹³. Since DoD's savings projections have not adequately accounted for these costs, the expected level of savings is significantly reduced in the short-term¹¹⁴.

c. Transfer of Costs

Some outsourcing initiatives which appear to reduce costs merely do so by transferring a portion of their costs to other organizations. For instance, cost reductions achieved through privatized housing are often incurred as higher outlays for housing allowance¹¹⁵. If a base manages its own housing units, the housing allowance due to the residents is retained by the base to cover its maintenance expenses. If the housing is privatized, the base is no longer responsible for maintaining the housing units and is able to reduce its maintenance budget. But, at the same time, it must begin to pay housing allowance to its residents so they, in turn, can pay rent to the contractor. Unless the increase in housing allowance is considered in the outsourcing analysis, the cost estimates will not be accurate and savings will be overstated. A similar scenario can occur when military workers are replaced with civilian workers.

Many agencies use substantially fewer workers when military personnel are replaced with civilians. In fact, some agencies estimate the ratio of workers needed to be 0.6 civilians for each military position¹¹⁶. The reason for this low substitution factor is that military members are often unavailable at their primary duty station due to

¹¹³ United States General Accounting Office, and United States. Dept. of Defense. Defense Management: DOD Faces Challenges Implementing its Core Competency Approach and A-76 Competitions. Washington, D.C: U.S. General Accounting Office, 2003.

¹¹⁴ United States General Accounting Office. DOD Competitive Sourcing: Questions about Goals, Pace, and Risks of Key Reform Initiative. Vol. GAO/NSIAD-99-46, February 22, 1999.

¹¹⁵ Chad M. Brooks, Edward J. White, and David E. Moore. Outsourcing Options to Meet Navy Recapitalization Goals. Naval Postgraduate School, 2004. Monterey, California.

¹¹⁶ Susan M. Gates, and Albert A. Robbert. Personnel Savings in Competitively Sourced DoD Activities: Are they Real? Will they Last?. RAND, 2000.

training, local details, or deployments. However, whenever the civilianization of military positions is used to reduce the size of the workforce, some of the assumed savings may be difficult to realize¹¹⁷.

If the training, details, and deployments meet valid and continuing defense requirements, the burden of supporting them is not eliminated by civilianization. Rather, the burden is shifted to other agencies with military workforces¹¹⁸. An example would be communications personnel who were replaced by civilian personnel and then transferred to a different base that still used military communications personnel. The increase in personnel costs at the other base would need to be included in the analysis to determine the true cost of outsourcing the positions.

A second concern is that even though military positions may be outsourced, the overall military authorizations in that service may not decline because the military positions that are deleted from one function are put to use in another function¹¹⁹. An example would be if communications billets were eliminated and then the billets were increased in the intelligence career field. In either scenario, the end result of an outsourcing initiative that reduced costs could actually be a net *increase* in personnel costs for the DoD if the cost reductions in the outsourcing agency do not outweigh the personnel costs that were transferred to another agency or unit.

d. Forced Labor Rates

Contractors are required, by law, to provide their employees working under government contracts with a minimum level of pay and benefits. Specifically, service workers are covered by the Service Contract Act of 1965 and construction workers are covered by the Davis Bacon Act of 1931. Both of these acts direct that the Department of Labor establish flat hourly rates for skill classifications in different

¹¹⁷ Susan M. Gates, and Albert A. Robbert. Personnel Savings in Competitively Sourced DoD Activities: Are they Real? Will they Last?. RAND, 2000.

¹¹⁸ Susan M. Gates, and Albert A. Robbert. Personnel Savings in Competitively Sourced DoD Activities: Are they Real? Will they Last?. RAND, 2000.

¹¹⁹ Susan M. Gates, and Albert A. Robbert. Personnel Savings in Competitively Sourced DoD Activities: Are they Real? Will they Last?. RAND, 2000.

geographic areas based on the median level of pay for each job classification in each area¹²⁰. These rates are periodically reviewed and updated as necessary.

The result of these acts is that contractors are essentially *forced* into paying these rates to every worker, regardless of the nature of the work being performed. This occurs because the contractors are not allowed to pay their workers below the minimum rate. At the same time, they will usually not desire to pay their workers above the rate because it would raise their costs and reduce the likelihood that they would be awarded the contract. Since the labor rate is equal to the median level of pay for the job classification in the local area, the government often pays for an “average” worker regardless of the skill level that is actually required to perform the work. If the work could be done by a lower-skilled worker, the government ends up paying for an over-qualified worker. If the work should be done by a higher-skilled worker, there may be quality issues to address.

e. Imprecise Cost Factors

Cost estimates are based on assumptions. The validity and accuracy of these assumptions have a direct impact on the validity and accuracy of the cost estimate. There are three primary cost factors, or assumptions, that have come under a lot of scrutiny. They include the minimum cost differential, the personnel cost overhead rate, and the personnel cost estimates.

In order to win a competition, the contractor must meet a minimum cost differential of at least 10% or \$10M, whichever is lower, less than the MEO’s proposal¹²¹, which is intended to cover the transition costs required to convert from government to contractor performance. The authors find three main problems with this cost differential.

First, it assumes that all contracts will have transition costs equal to the minimum cost differential. Not only is this blatantly naïve, but it fails to consider that

¹²⁰ United States General Accounting Office. DOD Competitive Sourcing: Effects of A-76 Studies on Federal Employees’ Employment, Pay, and Benefits Vary. Washington, D.C: U.S. General Accounting Office, 2001.

¹²¹ Valerie Bailey Grasso. Defense Outsourcing: The OMB Circular A-76 Policy. Washington, D.C: Congressional Research Service, 2005.

some contracts, such as those performing very large or complex tasks, can have drastically different transition costs than those performing other smaller or simpler tasks.

Second, the rate is not uniform across different costs. For instance, if the MEO bid \$1,000, the contractor would need to bid \$900 (\$100, or 10%, lower than the MEO bid) to win the contract. If the contract was much larger and the MEO bid \$1B, the contractor would only need to bid \$990M (\$10M, or 1%, lower than the MEO bid) to win the contract.

Third, the rate is very arbitrary in nature. For instance, if the MEO bid \$95.0M and the contractor bid \$85.6, or \$9.4M less, the contractor would not win the competition because it failed to meet the minimum cost differential. However, if the MEO had instead bid \$95.2M, the contractor would have met the differential and been awarded the contract. It seems that a contract of such magnitude should be decided upon by more than a mere 0.20% (\$200k/\$95M) difference in cost. At present, there does not appear to be much leeway for the agency to use its own discretion to weigh the transition costs versus the cost savings for its particular requirement.

Since 1996, MEO cost estimates have applied a flat overhead rate of 12% to direct personnel costs¹²². This overhead rate is intended to cover two types of overhead: operations overhead and general and administrative (G&A) overhead. Operations overhead includes costs that are not 100% attributable to the activity, but are generally associated with recurring management and support of the activity. G&A overhead includes the salaries, equipment, space, and other activities related to headquarters management, accounting, personnel, legal support, data processing management, and similar common services performed outside the activity¹²³.

There are indications that the 12% overhead rate can misstate the marginal cost of overhead support for in-house performance. Operations overhead is often undiminished by outsourcing because outsourcing does not reduce the command, executive, and functional oversight responsibilities at higher organizational levels such as

¹²² Susan M. Gates, and Albert A. Robbert. Personnel Savings in Competitively Sourced DoD Activities: Are they Real? Will they Last?. RAND, 2000.

¹²³ Susan M. Gates, and Albert A. Robbert. Personnel Savings in Competitively Sourced DoD Activities: Are they Real? Will they Last?. RAND, 2000.

the installation, major command, or service headquarters. G&A overhead is often undiminished because contractors occupy government-furnished facilities and use government-furnished equipment and parts. In fact, the only significant overhead costs saved through outsourcing are associated with the personnel and payroll support of the displaced workforce¹²⁴.

Furthermore, GAO has voiced concern that this rate, which is specified in the A-76 Circular, lacks an analytical basis and may be overstating, or understating, the overhead costs associated with in-house performance¹²⁵. In fact, the 12% rate is reportedly nothing more than a compromise between private-sector interests, which argued for government overhead rates ranging from 15-30%, and rates used in earlier A-76 competitions, which generally ranged from 0-3%¹²⁶. If true, this allegation would seriously question the validity of the rate.

MEO cost estimates use the salary of a General Service (GS) employee at step 5, and a Federal Wage System (FWS) worker at step four plus a fringe rate stipulated in the A-76 Circular. There has been concern that these cost estimates may not be very accurate because they are not based on the actual personnel costs associated with the individuals occupying the particular positions¹²⁷.

This method of determining personnel costs could lead to either an overestimate or underestimate of the actual baseline personnel costs. If the workforce has been in place a long time and there is little turnover, the average pay level is likely to be above step five for GS workers and four for FWS workers. In such a situation, the actual

¹²⁴ Susan M. Gates, and Albert A. Robbert. Personnel Savings in Competitively Sourced DoD Activities: Are they Real? Will they Last?. RAND, 2000.

¹²⁵ United States General Accounting Office. Defense Outsourcing: Better Data Needed to Support Overhead Rates for A-76 Studies. Vol. GAO/NSIAD-98-62, February 1998.

¹²⁶ United States General Accounting Office. Defense Outsourcing: Better Data Needed to Support Overhead Rates for A-76 Studies. Vol. GAO/NSIAD-98-62, February 1998.

¹²⁷ Susan M. Gates, and Albert A. Robbert. Personnel Savings in Competitively Sourced DoD Activities: Are they Real? Will they Last?. RAND, 2000.

wage and salary costs would be underestimated. On the other hand, if there is high turnover and the average step is low, the estimates would overestimate the actual wage and salary costs¹²⁸.

f. Cost of Personnel Reductions

The majority of cost reductions from outsourcing competitions come from reductions in personnel, which are often the result of a reduction in work scope¹²⁹. In principle, the scope of work is reduced because the function is no longer needed. But many times it is instead the result of the DoD agency doing a poor job defining the work package that is to be performed by the contractor¹³⁰. Oftentimes a reduction in personnel is only associated with contractor performance. The fact is that even when the MEO wins an A-76 competition, the new in-house organization typically restructures the work and reduces its number of employees¹³¹. The end result is that regardless of whether the reduction in work scope is intentional and what organization wins the competition, the size of the work force is usually reduced.

As has been previously discussed in this chapter, the estimated cost savings associated with contractor performance are often overestimated. Unfortunately, the same is also true when the MEO is implemented. After winning the competition, the in-house organization will usually conduct a Reduction In Force (RIF) to scale the organization down to its proposed size.

During a RIF, the DoD offers eligible personnel a cash incentive of up to \$25,000 to retire or voluntarily separate¹³². Those who do not voluntarily separate are either given a position within the new organization or are given priority placement into

¹²⁸ Susan M. Gates, and Albert A. Robbert. Personnel Savings in Competitively Sourced DoD Activities: Are they Real? Will they Last?. RAND, 2000.

¹²⁹ United States General Accounting Office. DOD Competitive Sourcing: Results of Recent Competitions. Vol. GAO/NSIAD-99-44, February 23, 1999.

¹³⁰ Susan M. Gates, and Albert A. Robbert. Personnel Savings in Competitively Sourced DoD Activities: Are they Real? Will they Last?. RAND, 2000.

¹³¹ United States General Accounting Office. DOD Competitive Sourcing: Effects of A-76 Studies on Federal Employees' Employment, Pay, and Benefits Vary. Washington, D.C: U.S. General Accounting Office, 2001.

¹³² United States General Accounting Office. DOD Competitive Sourcing: Effects of A-76 Studies on Federal Employees' Employment, Pay, and Benefits Vary. Washington, D.C: U.S. General Accounting Office, 2001.

other jobs within DoD for which they are qualified. Oftentimes, the personnel remaining in the organization are downgraded to lower-graded positions. The purpose is to lower the average personnel pay grade and reduce the organization's personnel costs. Unfortunately, this is usually little more than an exercise on paper. According to RIF procedures, government employees who accept a lower-graded position is eligible to retain their former grade and pay for two years. At the end of the two year period, if the employees remain in the same position, their grade may be lowered but their pay is not¹³³.

The following example, from Wright-Patterson Air Force Base, is a fairly typical illustration of how government personnel are affected when the MEO wins the A-76 competition¹³⁴. The facts are as follows: The organization originally had 623 personnel; 428 civilian and 195 military. After the competition, all of the military were assigned to other duties and 83 full-time civilian positions were eliminated. Of those eliminated, 28 obtained other government positions, 53 chose voluntary separation, and 2 were involuntarily separated. Of the remaining 345 civilians in the organization, 52% experienced a reduction in grade, 31% remained at their same grade level, 1% obtained a higher grade level, and 15% changed wage systems, making it difficult to determine the impact on their grade level. A visual representation is depicted in Figure 1 below.

¹³³ United States General Accounting Office. DOD Competitive Sourcing: Effects of A-76 Studies on Federal Employees' Employment, Pay, and Benefits Vary. Washington, D.C: U.S. General Accounting Office, 2001.

¹³⁴ United States General Accounting Office. DOD Competitive Sourcing: Effects of A-76 Studies on Federal Employees' Employment, Pay, and Benefits Vary. Washington, D.C: U.S. General Accounting Office, 2001.

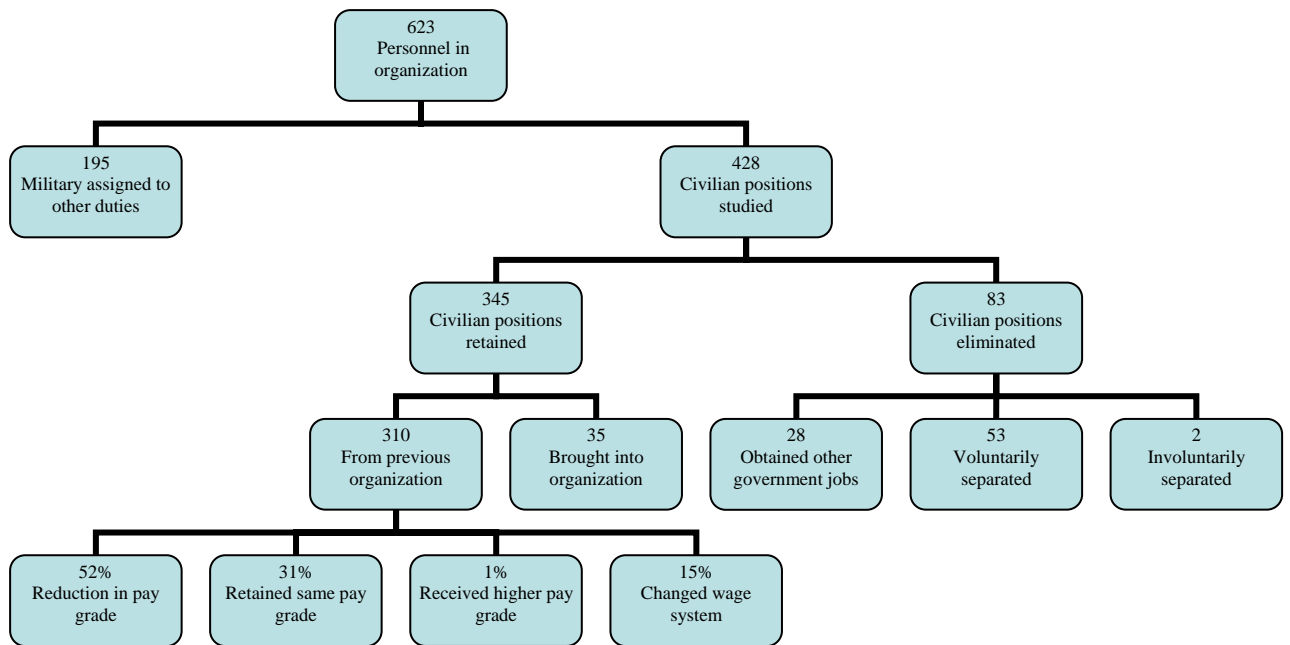


Figure 1. Break-down of Personnel Affected by Outsourcing

Source: Author created from DOD Competitive Sourcing: Effects of A-76 Studies on Federal Employees' Employment, Pay, and Benefits Vary

The government advertised an estimated \$97M in cost reductions by implementing the MEO. After all, they eliminated 278 of 623 positions (almost 45%), and reduced the pay grade of over half of the remaining personnel. Assuming that the reduction in personnel will not adversely affect the unit's mission readiness, this outsourcing competition appears to be very successful indeed.

However, we can use the same facts to tell a very different story. There were originally 623 personnel in the organization. After the MEO was implemented, 195 military members and 28 civilian personnel were moved into other government positions. These personnel were taken off the organization's payroll but, since they are still government employees, their salaries are just transferred to different government organizations. In sum, the government, in its entirety, only realized a reduction of 55 positions (a mere 9%). And, of the 55 positions that were eliminated, 53 were paid upwards of \$25,000 each, or \$1,325,000 total, to separate voluntarily. Furthermore, while over half of the remaining personnel were reduced in grade, no immediate cost savings will be realized since they will retain their same pay indefinitely.

When we consider that only two positions were eliminated at no-cost, upwards of \$1.325M was paid to separating employees, and an estimated \$3,000 per competed position was spent to conduct the competition (see “Acquisition and Investment Costs” in Section D of this chapter), it appears that this outsourcing initiative may have actually *cost* the government almost \$3.2M. This example serves as a perfect illustration of how cost savings can be overestimated even when the in-house organization wins the A-76 competition.

g. Cancelled Competitions

Another reason for high-cost estimates is cancelled outsourcing competitions. The savings estimates used by the DoD are based on the number of positions slated for competition. However, historically, more than 40% of initiated competitions have been cancelled before completion¹³⁵. While there is no available data on the cost savings generated by these cancelled competitions, we can assume that they are low because when a competition is cancelled, the activity normally remains in-house, and the in-house management is under no obligation to implement the MEO or otherwise improve efficiency¹³⁶. In addition, there will be some costs incurred, albeit less than a completed competition, for each of these cancelled competitions. Therefore, even if *completed* competitions do yield the advertised 30% savings, the expected savings generated by each *initiated* competition are far less¹³⁷.

3. Overstated Cost Savings

The result of these seven reasons appears to be overstated cost savings from A-76 competitions. In a 1997 report on the outsourcing of DoD logistics functions, GAO concluded that \$4B out of \$6B in projected savings were overstated due to errors in estimates, dubious assumptions, and legal and cultural barriers¹³⁸. Two years later, in

¹³⁵ Albert A. Robbert, Susan M. Gates, and Marc N. Elliott. Outsourcing of DoD Commercial Activities: Impacts on Civil Service Employees. Vol. MR-866-OSD. RAND, 1997.

¹³⁶ Susan M. Gates, and Albert A. Robbert. Personnel Savings in Competitively Sourced DoD Activities: Are they Real? Will they Last?. RAND, 2000.

¹³⁷ Susan M. Gates, and Albert A. Robbert. Personnel Savings in Competitively Sourced DoD Activities: Are they Real? Will they Last?. RAND, 2000.

¹³⁸ United States General Accounting Office. Outsourcing DOD Logistics: Savings Achievable but Defense Science Board's Projections are Overstated. Vol. GAO/NSAID 98-048. Washington D.C.: December 1997.

1999, GAO auditors concluded that their 1998 estimates of savings from competitions were too high and that the estimated savings between FY1997 and FY2003 were overstated¹³⁹. In 2000, GAO again revised many of their cost-savings estimates and reduced their cost-savings goals even further¹⁴⁰.

It should be noted that it is very difficult to track cost savings over time because of changing workload requirements and the effects these changes have on program costs and the baseline from which the estimates are calculated¹⁴¹. Even so, savings resulting from A-76 competitions have reportedly ranged from 20-30% lower than original projections¹⁴².

4. Funding Shortfalls

The DoD is trying to use the A-76 process to shift military personnel away from commercial-type functions and into those more directly related to warfighting. The Air Force, in particular, has made this a high priority but has not been able to outsource its military positions as quickly as it would like. In fact, the number one *unfunded* priority for the Air Force in FY2004 was \$2.34B to move 6,300 military positions out of non-core functions¹⁴³. This brings up a very interesting question. If outsourcing results in cost savings, why did the Air Force not have the funding necessary to outsource these positions?

The answer is that many outsourcing competitions actually *create* funding shortfalls. When the outsourcing activities publicize their cost-savings estimates, their budget is usually reduced by the DoD to reflect the savings. Then the DoD, in turn,

¹³⁹ United States General Accounting Office. DOD Competitive Sourcing: Questions about Goals, Pace, and Risks of Key Reform Initiative. Vol. GAO/NSIAD-99-46, February 22, 1999.

¹⁴⁰ United States General Accounting Office. DOD Competitive Sourcing: Some Progress, but Continuing Challenges Remain in Meeting Program Goals. Vol. GAO/NSIAD 00-106. Washington D.C., August 2000.

¹⁴¹ United States General Accounting Office. DOD Competitive Sourcing: Results of A-76 Studies Over the Past 5 Years: Report to Congressional Committees. Washington, D.C: U.S. General Accounting Office, 2000.

¹⁴² Valerie Bailey Grasso. Defense Outsourcing: The OMB Circular A-76 Policy. Washington, D.C: Congressional Research Service, 2005.

¹⁴³ United States General Accounting Office, and United States. Dept. of Defense. Defense Management: DOD Faces Challenges Implementing its Core Competency Approach and A-76 Competitions. Washington, D.C: U.S. General Accounting Office, 2003.

either has its budget reduced by Congress or redistributes the savings to other projects. Either way, the funding is no longer available for the original activity to use.

As long as the outsourcing competitions realize their estimated cost savings, everyone is satisfied. However, if the competitions fall short of their savings estimates, even by a small amount, funding shortfalls are created. To illustrate, we will assume that a particular organization estimates \$10M in cost savings by outsourcing and then falls 20% short of its estimate. In this case, the outsourcing competition would create a \$2M shortfall despite the fact that it also reduced the organizations costs by \$8M. When a situation like this occurs, the outsourcing activity has to either absorb the shortfall internally or ask for more funding from DoD. Either way, tough decisions will need to be made, and other projects and missions will likely suffer.

5. Conclusion

There are two conclusions from this section. The first, that cost savings are often overestimated, is probably not very surprising. The second, that cost savings can actually create funding shortfalls, is not so intuitive. Ironically, as we saw in the previous subsection, it is often the competitive sourcing process itself that suffers from its own shortcomings.

E. FAIR ACT AND THE PRESIDENT’S MANAGEMENT AGENDA

1. FAIR Act

The Federal Activities Inventory Reform (FAIR) Act was signed into law on October 19, 1998¹⁴⁴. It required that the heads of each executive agency review their agencies activities and submit to the Director of OMB and Congress a list of the activities performed by government employees which, in their opinion, were not inherently governmental¹⁴⁵. In this case, the definition used for inherently governmental was “those [activities] so intimately related to the exercise of the public interest as to mandate

¹⁴⁴ Valerie Bailey Grasso. Defense Outsourcing: The OMB Circular A-76 Policy. Washington, D.C: Congressional Research Service, 2005.

¹⁴⁵ 31 United States Code 501 Pub. L. 105-270. Federal Activities Inventory Reform, 1998.

performance by federal employees”¹⁴⁶. In all, a total of 850,000 commercial positions were identified throughout the federal government.

2. The President’s Management Agenda

In August 2001, President Bush unveiled “The President’s Management Agenda” (PMA), which identified competitive sourcing as one of five management initiatives designed to enhance government effectiveness¹⁴⁷. The goal of the competitive sourcing initiative was to “simplify and improve the procedures for evaluating public and private sources, to better publicize the activities subject to competition, and to ensure senior level agency attention to the promotion of competition”¹⁴⁸.

As part of the PMA, the Bush Administration directed that half of the 850,000 commercial positions identified in the FAIR Act be competed or directly converted to private sector performance by the end of FY2008¹⁴⁹. As it turned out, 453,000 of these positions were within the DoD. The DoD was given interim targets to compete 15% (68,000 positions) by the end of FY2003 and 50% (226,000 positions) by the end of FY2008¹⁵⁰.

3. Problems Meeting Goals

DoD reported that as of June 1, 2003, it has met OMB’s short-term goal of competing 15% of the positions identified in DoD’s commercial activities inventory by the end of fiscal year 2003¹⁵¹. However, meeting the longer-term goal to compete at least 50% (226,000) of the positions before the end of FY2008 is presenting a challenge.

There are two reasons why the next goal is presenting such a challenge. The first is that the DoD has chosen to conduct the simplest competitions to this point. This means

¹⁴⁶ Office of Federal Procurement Policy. Inherently Governmental Functions. Vol. Letter 92-1, September 23, 1992.

¹⁴⁷ Office of Management and Budget. The President's Management Agenda for FY2002, 2001.

¹⁴⁸ Office of Management and Budget. The President's Management Agenda for FY2002, 2001.

¹⁴⁹ Valerie Bailey Grasso. Defense Outsourcing: The OMB Circular A-76 Policy. Washington, D.C: Congressional Research Service, 2005.

¹⁵⁰ United States General Accounting Office, and United States. Dept. of Defense. Defense Management: DOD Faces Challenges Implementing its Core Competency Approach and A-76 Competitions. Washington, D.C: U.S. General Accounting Office, 2003.

¹⁵¹ United States General Accounting Office, and United States. Dept. of Defense. Defense Management: DOD Faces Challenges Implementing its Core Competency Approach and A-76 Competitions. Washington, D.C: U.S. General Accounting Office, 2003.

that each new competition is more difficult and resource-intensive than the one before. The result has been a steady decline in the number of new competitions announced each year.

As can be seen in Figure 2, there is a significant lag-time from when an outsourcing competition is announced to when it is completed. Although the number of positions completed has been steadily increasing, the decline in positions announced means that there are consistently fewer positions under competition at any one time. Already we have reached the point where the positions completed curve is moving parallel to the positions announced curve. This means that there cannot be a significant increase in the number of positions completed unless there is a correspondingly significant increase in the positions announced for competition.

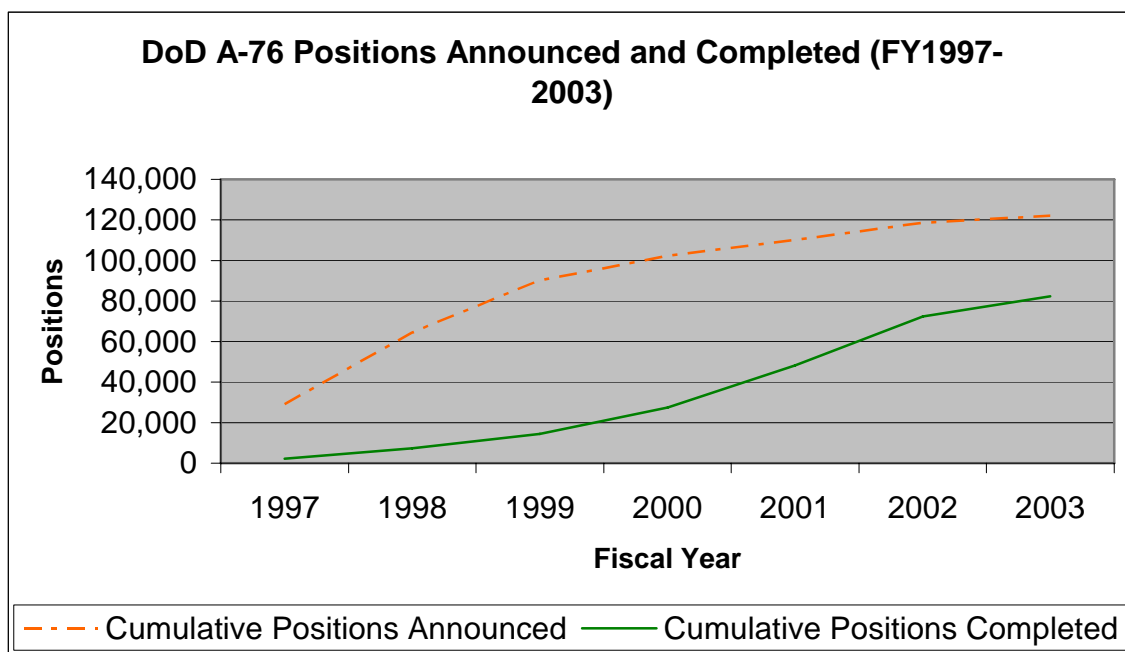


Figure 2. DoD A-76 Positions Announced and Completed (FY1997-2003)

Source: Author created from Defense Management: DOD Faces Challenges Implementing its Core Competency Approach and A-76 Competitions and Competitive Sourcing: Greater Emphasis Needed on Increasing Efficiency and Improving Performance

The second reason why the next goal is so challenging is that it represents a large increase in the number of competitions in a short period of time. In fact, the number of positions competed between FY1997 and FY2003 was twice the number competed between FY1978 and FY1996¹⁵², and the number of positions proposed for competition between FY2003 and FY2008 is twice the number competed between FY1997 and FY2003¹⁵³. This means that the DoD has, and will need to continue, to exponentially increase the number of positions competed to meet OMB's goal.

This exponential rate of growth is shown in Figure 3. As was mentioned previously, the DoD was on pace to meet its goal as of June 1, 2003. From this point, the DoD needed to follow the "projected" line to reach its goal of 226,000 positions competed by the end of FY2008. As can be seen, through the end of FY2004, the DoD had already fallen behind the pace.

¹⁵² Susan M. Gates, and Albert A. Robbert. Personnel Savings in Competitively Sourced DoD Activities: Are they Real? Will they Last?. RAND, 2000.

¹⁵³ United States General Accounting Office. March 19 Hearing on Sourcing and Acquisition: Questions for the Record. Washington, D.C: 2003.

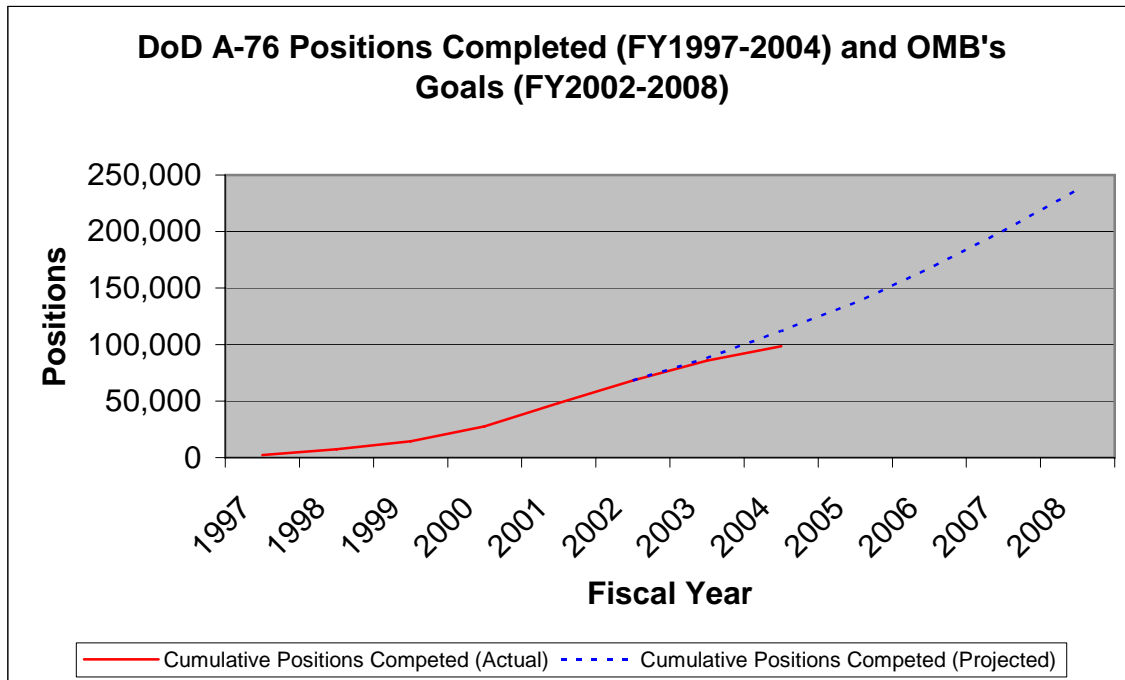


Figure 3. DoD A-76 Positions Completed (FY1997-2004) and OMB's Goals (FY2002-2008)

Source: Author created from DOD Faces Challenges Implementing its Core Competency Approach and Defense Outsourcing: The OMB Circular A-76 Policy

Serious questions have been raised as to whether the DoD components can in fact identify the expected number of positions for competition and then complete those competitions in the anticipated time frame¹⁵⁴.

4. Results

The authors find that OMB's aggressive outsourcing targets have had some negative results within the DoD. These results include small and inefficient outsourcing competitions, overstated cost savings, and a strain on acquisition personnel. Because the DoD is judged on its ability to meet OMB's targets, the DoD has focused its attention on the easiest outsourcing initiatives to post maximum results with minimum effort, rather

¹⁵⁴ Susan M. Gates, and Albert A. Robbert. Personnel Savings in Competitively Sourced DoD Activities: Are they Real? Will they Last?. RAND, 2000.

than focus on those competitions that are in the best interest of the unit or service. In particular, the DoD has completed mostly small competitions that receive less scrutiny and require fewer resources than larger competitions.

We can deduce the size of the competitions by combining two unique pieces of information. We know that private contractors currently win about 60% of the competitions, with the government MEO's winning the remainder¹⁵⁵. However, the MEO won 89% of the 17,595 positions competed in FY2003¹⁵⁶ and 90% of the 12,573 positions competed in FY2004¹⁵⁷. The most logical explanation is that most of the competitions are small and are won by contractors. At the same time, there are a few large competitions that are won by the government. This would explain how contractors can manage to win a majority of the competitions, but so few of the positions.

In the time between when the PMA was introduced in 2001 and August 2004, the DoD completed 501 A-76 initiatives, totaling 37,986 positions, which it claims generated \$5.2B, or 36%, in savings¹⁵⁸. However, because the majority of the competitions were so small, it can be assumed that these competitions generated a large ratio of expenses per position to compete and probably led to highly overstated cost-savings estimates.

The aggressive outsourcing targets have also created a strain on acquisition personnel. On March 19, 2003 the United States Senate Committee on Armed Services Subcommittee on Readiness and Management Support asked the following question to David Walker, Comptroller General of the United States:

Would you agree that the challenges of meeting the Administration's goals for public-private competition, and of managing services contracts that result from such competition, are more likely to require an increase in acquisition resources than a decrease¹⁵⁹?

¹⁵⁵ Valerie Bailey Grasso. Defense Outsourcing: The OMB Circular A-76 Policy. Washington, D.C: Congressional Research Service, 2005.

¹⁵⁶ Office of Management and Budget. Report on Competitive Sourcing Results, Fiscal Year 2003, March, 2005.

¹⁵⁷ Office of Management and Budget. Report on Competitive Sourcing Results, Fiscal Year 2004, May 2005.

¹⁵⁸ United States Department of Defense. The President's Management Agenda: The Results for the Department of Defense, August 9, 2004.

¹⁵⁹ United States General Accounting Office. March 19 Hearing on Sourcing and Acquisition: Questions for the Record. Washington, D.C: 2003.

On May 23, 2003, Walker responded with the following:

The Administration's goals for conducting public-private competitions could have a significant impact on the acquisition workforce in a number of ways. First, as noted by the Commercial Activities Panel, the current process for conducting these competitions are complicated, and therefore requires a skilled acquisition workforce to support the studies.

Second, the number of positions proposed for study in the coming years is significantly higher than in the past, greatly increasing the competitive sourcing workload at many agencies. At DoD, for example, the number of positions proposed for study during the next five years is double what the department had been able to review between fiscal years 1997 and 2002.

Finally, to the extent that an increase in competitive sourcing studies result in an increase in the award of service contracts to the private sector, agencies will need to ensure that they have sufficient acquisition workforce in numbers and abilities to administer those contracts effectively¹⁶⁰.

Since there has not been a substantial increase in the number of acquisition personnel since this testimony, we can assume that this problem is still lingering and that the DoD will not be able to increase the number of competitions conducted each year unless it is given the necessary resources to do so.

F. PROBLEMS WITH OUTSOURCING COMPETITIONS

1. Introduction

To date, the DoD has encountered several challenges with its outsourcing process. These challenges include poor cost estimates, problems with contracts, making decisions based on lowest cost versus best value, conflicts of interest, competition delays, and a shortage of personnel manning and expertise.

2. Poor Cost Estimates

From Section D of this chapter we know that DoD cost-savings estimates are usually high and are often the result of poorly defined work requirements and insufficient Performance Work Statements. After the requirement is outsourced, costs often increase as the contract is modified to add work that was not included in the original contract. We also know that the outsourcing agencies often fail to include acquisition, investment, and

¹⁶⁰ United States General Accounting Office. March 19 Hearing on Sourcing and Acquisition: Questions for the Record. Washington, D.C: 2003.

transition costs in their analysis. In addition, baseline cost estimates are often erroneous and accurate post-award or MEO cost savings are difficult to determine because of deficiencies in the CAMIS database system.

There is also debate over the minimum cost differential requirement, which requires the contractor bid to be at least 10% or \$10M, whichever is lower, less than the government estimate, and the 12% overhead rate. Defense contractors claim that both of these factors give the government an advantage in the outsourcing process.

We also know that the impact of high cost-savings estimates can be devastating to the DoD. When the agencies fail to include all of the A-76 costs in their projections, the cost savings are often less than the estimates and create funding shortfalls within the DoD.

3. Problems with Contracts

The DoD has experienced several problems with its outsourcing contracts. On March 10, 2000, the DoD Office of the Inspector General published the results of an audit of all service contracts for professional, administrative, and management support activities. The report revealed that the 15 contracting and program offices included in the study were not adequately managing the award and administration of their 105 contracts¹⁶¹. In fact, *every* contract had one or more of the following problems:

- Inadequate government cost estimates (77%);
- Non-use of prior history to define requirements (69%);
- Inadequate pricing negotiation memorandums (68%);
- Inadequate contract surveillance (67%);
- Inadequate competition (60%);
- Cursory technical reviews (57%);
- Lack of cost control (25%);
- Failure to award multiple-award contracts (18%).

¹⁶¹ United States Department of Defense Office of the Inspector General. Contracts for Professional, Administrative and Management Support Services. Vol. Audit Report No. D-2000-100, March 10, 2000.

The report also revealed that cost-type contracts, which place a higher risk on the government, continued without question for the same services for inordinate lengths of time (39 years in one extreme case) and there were no performance measures in use to judge the efficiency and effectiveness of the services rendered.

4. Lowest Cost versus Best Value

Until recently, the DoD focused almost exclusively on cost avoidance in the implementation of A-76 and did not necessarily consider a “best value” approach, which includes a combination of price, quality and performance, to competitive sourcing. In fact, GAO noted that the A-76 process has not worked well as the basis for competitions that work to identify the best provider in terms of quality, innovation, flexibility, and reliability¹⁶².

OMB is trying to change the low-cost mentality and provided more emphasis on best-value procurement in the 2003 A-76 revision. However, since there is still so much emphasis placed on cost savings, it is doubtful that we will see much of a shift in the near future. This cynical outlook is commonly held by many contractors. In general, they believe that government procurement specialists still decide contract awards based on the lowest cost, and not necessarily what would represent the best value to the government¹⁶³. In a 2004 interview, the Vice President for Business Development at an unnamed Fortune 100 company stated that:

Best value has a very subjective definition. We find there is much less attention paid to efficiencies, and ultimately the decisions are made solely on the basis of low cost, even where they say it is a best-value procurement¹⁶⁴.

5. Conflicts of Interest

In the fall of 1998, Wright-Patterson Air Force Base released a Request for Proposal for maintenance, operation, repair, and minor construction services for the base

¹⁶² Chad M. Brooks, Edward J. White, and David E. Moore. Outsourcing Options to Meet Navy Recapitalization Goals. Naval Postgraduate School, 2004. Monterey, California.

¹⁶³ Valerie Bailey Grasso. Defense Outsourcing: The OMB Circular A-76 Policy. Washington, D.C.: Congressional Research Service, 2005.

¹⁶⁴ Brett Stevens. An Analysis of Industry's Perspective on the Recent Changes to Circular A-76. Monterey, California: Graduate School of Business & Public Policy, Naval Postgraduate School, 2004. Monterey, California.

and subsequently received two proposals. The Air Force reviewed the proposals, determined that they were incomplete and unacceptable, and then canceled the original solicitation. The contractors filed protests with the GAO.

After concluding their investigation, GAO stated:

[The contractors] argue that the determination that their proposals were technically unacceptable - that is, the determination on which cancellation of the solicitation was based - resulted from a failure to conduct meaningful discussions, and an unreasonable evaluation of technical proposals by evaluators with an improper conflict of interest. In this latter regard, the protestors note that 14 of 16 evaluators - 4 of 6 core evaluators responsible for evaluating the entire proposals, and all 10 technical advisors responsible for evaluating specific portions of the proposals - held positions that were under study as part of the A-76 study¹⁶⁵.

The GAO concluded by stating that “We agree with the protestors that the evaluation process was fundamentally flawed as a result of a conflict of interest.”

The vice president mentioned in the previous subsection also witnessed a similar situation. In the fall of 2003, he and several other industry representatives were visiting a site in New Jersey that was being competed under A-76. As their tour of the facilities progressed, it became apparent that the tour guide was withholding needed information. At one point he even cancelled an entire portion of the tour, citing an obscure regulation that prevented the industry representatives from entering the area. In the end, it was revealed that the tour guide was one of the people whose job was being competed.

Unfortunately, stories like these are more commonplace than one may like to believe. It is because of situations like this that new rules to govern conflicts of interest were added during the 2003 A-76 revision. In particular, the new rules contain provisions that bar directly-affected government personnel, defined as personnel whose job is being competed, from participation “in any manner” on the Source Selection Evaluation Board. They also state that members of the government team that develop the PWS may not also be members of the government team that develop the MEO, thus

¹⁶⁵ United States General Accounting Office. GAO Bid Protest Decision. Vol. B-281224, January 12, 1999.

reducing the possibility of requirements tailoring¹⁶⁶. Since the rules are still relatively new, more time is needed to determine their impact.

6. Competition Delays

Because the DoD's A-76 studies have typically taken longer than originally planned, they have also used more resources and cost more to complete than originally planned¹⁶⁷. To shorten the time required to conduct a competition, the 2003 revision to the A-76 Circular states that standard competitions shall not exceed 12 months from public announcement (start date) to performance decision (end date), with 6 month extensions granted under certain conditions. However, the studies, historically, have taken substantially longer than 12-18 months. In fact, single-function studies have taken an average of 20 months, and multi-function studies have taken 35 months¹⁶⁸. Without an increase in the number of personnel assigned to the competitions or a more streamlined process, it seems nearly impossible for the DoD to meet this new timeline.

The A-76 Circular also states that agencies shall complete certain preliminary planning - such as work scope, baseline costs, and schedule - before public announcement¹⁶⁹. Only when these tasks are completed and the public announcement is issued, will the clock start ticking.

Since it is not clear how much time this preliminary planning has taken in the past¹⁷⁰, it is impossible to know how much, if at all, the timeline will be shortened because of this change. But the change may actually *lengthen* the process. Since the

¹⁶⁶ Brett Stevens. An Analysis of Industry's Perspective on the Recent Changes to Circular A-76. Monterey, California: Graduate School of Business & Public Policy, Naval Postgraduate School, 2004. Monterey, California.

¹⁶⁷ United States General Accounting Office, and United States. Dept. of Defense. Defense Management: DOD Faces Challenges Implementing its Core Competency Approach and A-76 Competitions. Washington, D.C: U.S. General Accounting Office, 2003.

¹⁶⁸ United States General Accounting Office, and United States. Dept. of Defense. Defense Management: DOD Faces Challenges Implementing its Core Competency Approach and A-76 Competitions. Washington, D.C: U.S. General Accounting Office, 2003.

¹⁶⁹ United States General Accounting Office, and United States. Dept. of Defense. Defense Management: DOD Faces Challenges Implementing its Core Competency Approach and A-76 Competitions. Washington, D.C: U.S. General Accounting Office, 2003.

¹⁷⁰ United States General Accounting Office, and United States. Dept. of Defense. Defense Management: DOD Faces Challenges Implementing its Core Competency Approach and A-76 Competitions. Washington, D.C: U.S. General Accounting Office, 2003.

preliminary planning is no longer part of the official timeline, this initial stage of the process may not be very visible or receive much scrutiny and outside oversight. If this occurs, the agencies may not devote their full attention to the competition, allowing the planning stage to drag on indefinitely.

7. Acquisition Personnel Manning and Expertise

Between fiscal years 1990 and 2001, DoD's acquisition workforce was reduced by more than 50%. At the same time, DoD's contracting workload increased by 12%¹⁷¹ due to increased reliance on services provided by commercial firms, changes to the federal acquisition process, and the introduction and expansion of alternative contracting approaches¹⁷². In February 2000, the Inspector General identified a number of adverse impacts attributable to these reductions in the DoD workforce. They include:

- Increased backlogs in closing out completed contracts;
- Increased program costs resulting from contracting for technical support versus in-house technical support;
- Insufficient personnel to fill in for employees on deployments;
- Insufficient staff to manage requirements, reduced scrutiny and timeliness in reviewing acquisition actions, personnel retention difficulty;
- Increased procurement action lead time;
- Lost opportunities to develop cost savings initiatives¹⁷³.

It should be noted that this list was prepared prior to September 11, 2001. We can only speculate the impact that Operation Enduring Freedom, Operation Iraqi Freedom, and the broader Global War On Terrorism have had on the DoD acquisition community.

In addition to an increased workload, contracting specialists today must also have a greater knowledge of market conditions, industry trends, and the technical details of the commodities and services they procure. In the end, the DoD has had difficulty adjusting to the significant changes in the federal acquisition environment and has experienced

¹⁷¹ United States General Accounting Office. March 19 Hearing on Sourcing and Acquisition: Questions for the Record. Washington, D.C: 2003.

¹⁷² United States General Accounting Office. Federal Procurement: Spending and Workforce Trends. Vol. GAO-03-443, April 30, 2003.

¹⁷³ Department of Defense Office of the Inspector General. DOD Acquisition Workforce Reduction Trends and Impacts. Vol. Report No. D-2000-088, February 29, 2000.

particular difficulty improving its acquisition of services and ensuring the appropriate use of contracting techniques and approaches¹⁷⁴. As a result, GAO has continually designated DoD's contract management as a high-risk area¹⁷⁵.

G. ALTERNATIVES TO A-76

1. Introduction

There are numerous problems with the A-76 process and there have been many ideas and proposals offered for alternative ways to conduct government outsourcing. This section will summarize a few of these ideas.

2. Commercial Activities Panel Recommendations

The Commercial Activities Panel was a congressionally-mandated, GAO-convened panel to study the policies and procedures governing the transfer of commercial federal activities from government personnel to federal contractors¹⁷⁶. The Panel's mission was "to improve the current sourcing framework and processes so they reflect a balance among taxpayer interests, government needs, employee rights, and contractor concerns"¹⁷⁷.

On 30 April 2002 the Panel released its final report, which included four recommendations. The first was the adoption of ten guiding principles for federal sourcing policy. They included:

- Support agency missions, goals, and objectives;
- Be consistent with human capital practices designed to attract, motivate, retain, and reward a high-performing federal workforce;
- Recognize that inherently governmental and certain other functions should be performed by federal workers;
- Create incentives and processes to foster high-performing, efficient, and effective organizations throughout the federal government;

¹⁷⁴ United States General Accounting Office. March 19 Hearing on Sourcing and Acquisition: Questions for the Record. Washington, D.C: 2003.

¹⁷⁵ United States General Accounting Office. Major Management Challenges and Program Risks: Department of Defense. Vol. GAO-03-98, January 2003.

¹⁷⁶ Valerie Bailey Grasso. Defense Outsourcing: The OMB Circular A-76 Policy. Washington, D.C: Congressional Research Service, 2005.

¹⁷⁷ United States General Accounting Office. Commercial Activities Panel: Improving the Sourcing Decisions of the Federal Government. Vol. GAO-02-866T, June 26, 2002.

- Be based on a clear, transparent, and consistently applied process;
- Avoid arbitrary full-time equivalent or other arbitrary numerical goals;
- Establish a process that, for activities that may be performed by either the public or private sector, would permit public and private sources to participate in competitions for work currently performed in-house, work currently contracted to the private sector, and new work, consistent with these guiding principles;
- Ensure that, when competitions are held, they are conducted as fairly, effectively, and efficiently as possible;
- Ensure that competitions involve a process that considers both quality and cost factors;
- Provide for accountability in connection with all sourcing decisions¹⁷⁸.

The remaining three recommendations were the abolishment of OMB Circular A-76, replacing it with an “integrated competition process” that combines elements of OMB Circular A-76 with the Federal Acquisition Regulation (FAR); the implementation of limited changes to the Circular that do not require legislation; and the move to develop federal agencies into high-performing organizations, known as HPO’s¹⁷⁹.

3. Senior Executive Council Recommendations

The Senior Executive Council is a high-level management committee which was established in 2001 to help guide efforts across the DoD to transform and improve the department’s business practices, and to function as a board of directors. The Council is chaired by the Secretary of Defense and is comprised of the Deputy Secretary of Defense, the service secretaries, and the Under Secretary of Defense for Acquisition, Technology, and Logistics¹⁸⁰.

¹⁷⁸ United States General Accounting Office. Commercial Activities Panel: Improving the Sourcing Decisions of the Federal Government. Vol. GAO-02-866T, June 26, 2002.

¹⁷⁹ Valerie Bailey Grasso. Defense Outsourcing: The OMB Circular A-76 Policy. Washington, D.C: Congressional Research Service, 2005.

¹⁸⁰ United States General Accounting Office, and United States. Dept. of Defense. Defense Management: DOD Faces Challenges Implementing its Core Competency Approach and A-76 Competitions. Washington, D.C: U.S. General Accounting Office, 2003.

One of the business-transformation initiatives that have been endorsed by the Council is a core competency-based approach for making sourcing decisions - that is, making sourcing decisions based on whether the function is core to the agency's warfighting missions. In April 2002, the Council launched a DoD-wide effort to distinguish between core and non-core functions with an emphasis on retaining in-house only those functions deemed core to the warfighting mission. Under this approach, the Council tasked the defense components with developing plans to transition non-core functions to alternative sourcing arrangements or A-76 studies, if appropriate, as soon as possible¹⁸¹.

The Council noted that A-76 cost comparisons are lengthy, expensive, and hard on the workforce. It recommended that the DoD use alternative arrangements such as public-private partnering, employee stock ownership, and quasi-governmental organizations¹⁸².

4. Come As You Are Competition

An idea proposed by RAND is to broaden A-76 incentives to all commercial activities, not just those identified for study, by requiring all activities to compete on a "come as you are" basis¹⁸³. Under this approach, the organization in place at the time a study is announced would compete against the best private-sector bid.

Since a competition could be announced at any time, this approach would force managers to continually evaluate their organizations and implement measures to increase efficiency. This incentive to improve efficiency would even be amplified because the activities that make themselves more efficient would not only fare better if eventually competed, but they would also face a lower probability of having to undergo an A-76

¹⁸¹ United States General Accounting Office, and United States. Dept. of Defense. Defense Management: DOD Faces Challenges Implementing its Core Competency Approach and A-76 Competitions. Washington, D.C: U.S. General Accounting Office, 2003.

¹⁸² United States General Accounting Office, and United States. Dept. of Defense. Defense Management: DOD Faces Challenges Implementing its Core Competency Approach and A-76 Competitions. Washington, D.C: U.S. General Accounting Office, 2003.

¹⁸³ Susan M. Gates, and Albert A. Robbert. Personnel Savings in Competitively Sourced DoD Activities: Are they Real? Will they Last?. RAND, 2000.

competition in the first place¹⁸⁴. In addition, the authors of the plan wrote that “when all in-house commercial activities face a weaker incentive to become efficient, the [cost] savings might be greater than when only a subset of commercial activities, identified for A-76 studies, face a somewhat stronger incentive¹⁸⁵.”

5. Transaction Cost Economics

According to Craig Powell, the Transaction Cost Economics (TCE) concepts of asset specificity, complexity, and frequency can provide DoD personnel with a powerful tool to evaluate outsourcing actions¹⁸⁶. He believes that providing TCE training to acquisition personnel would provide a better understanding of the economic forces that are at work in the outsourcing process. This training would not be a replacement for training in current DoD and service-specific acquisition guidelines, but would rather complement existing training.

There is often a conflict of goals between the participants in the outsourcing process. Integrating the principles of TCE into the outsourcing process could help all of the participants to overcome their different goals and perspectives and establish uniform criteria to evaluate the A-76 function under study. For this to occur, the training would need to extend past acquisition personnel, such as comptrollers and contracting officers, and include the leaders of the organization undergoing the A-76 study.

6. Improving Efficiency without Competition

A completely different alternative to the A-76 process is to not outsource a function, but rather to improve its efficiency without competition. RAND claims that the local commanders and local functional managers have the detailed process knowledge required to identify opportunities for cost savings, but also face the strongest disincentives to undertake change¹⁸⁷. The DoD could use both individual and

¹⁸⁴ Susan M. Gates, and Albert A. Robbert. Personnel Savings in Competitively Sourced DoD Activities: Are they Real? Will they Last?. RAND, 2000.

¹⁸⁵ Susan M. Gates, and Albert A. Robbert. Personnel Savings in Competitively Sourced DoD Activities: Are they Real? Will they Last?. RAND, 2000.

¹⁸⁶ Craig A. Powell. Transaction Cost Economics and A-76: A Framework for Defense Managers. Naval Postgraduate School, 2002. Monterey, California.

¹⁸⁷ Susan M. Gates, and Albert A. Robbert. Personnel Savings in Competitively Sourced DoD Activities: Are they Real? Will they Last?. RAND, 2000.

organizational rewards to prompt change. This would give the managers and their workforces an opportunity to earn performance, gainsharing, or goalsharing bonuses for their cost-saving effort. In addition, the organizations could be allowed to use a portion of the cost savings to pay for their top unfunded requirements. Another option is to have DoD performance evaluations explicitly consider the extent to which managers identified and implemented cost saving measures¹⁸⁸.

7. Summary

This section is not an all-inclusive listing of the many ideas and proposals offered for alternate ways to conduct government outsourcing. Rather, its intent is to show that there *are* different ways, besides the A-76 process, to accomplish outsourcing and improve organizational efficiency. While we give more credence to some ideas over others, they all deserve merit for being innovative and diverging from standard thinking. Unfortunately, the ideas mentioned in this chapter are moot. Until the OMB rescinds its goal to conduct A-76 competitions, it is unlikely that the DoD will pursue any alternate forms of outsourcing on a large scale.

¹⁸⁸ Susan M. Gates, and Albert A. Robbert. Personnel Savings in Competitively Sourced DoD Activities: Are they Real? Will they Last?. RAND, 2000.

III. DATA

A. BACKGROUND INFORMATION

The Air Force base from which we obtained information is located within the United States; possesses several flying squadrons, both airlift and fighter; and has over 7,400 personnel assigned to it. At the time of this particular competition, the Air Force was wrapping up an overall restructuring of the supply system. The supply squadron, prior to its outsourcing, was responsible for general supply services on the base to include the following: requisition, receiving, inspecting, storing, issuing, delivering, shipping, transferring, and disposal of supplies and equipment assets for the wing customers, tenant units, contractor operated sites, and transient customers of the base. In the case of the contractor who won by the outsourcing process, they were to continue providing these same services as specified in the contract. The outsourcing process was conducted according to OMB Circular A-76 guidelines in place at the time in an attempt to cut costs of a function that was not considered inherently governmental. The end result was anticipated compounded cost savings from both the supply restructuring effort and decreased costs associated with the base level operations being competed via A-76 procedures.

B. EXPLANATION OF SOURCES OF DATA

The sources of cost data are varied for the analysis of outsourcing actions being studied. The budget office of the Comptroller Squadron (CPTS) for the base which is being analyzed provided information on the actual obligations incurred by the Wing (WG) for the years the contract was in effect: the last four months of Fiscal Year 2001 (FY01) through the last option year of the contract, Fiscal Year 2005 (FY05). The forecasted obligations of the new contract put in place in Fiscal Year 2006 (FY06) was also provided along with the obligations for the Supply Squadron (SUPS) for the ten fiscal years prior to the outsourcing contract going into full effect: Fiscal Years 1991-2000 (FY91-FY00). All of the obligations provided were broken out by major categories

of expense. Examples include Civilian Pay, Supplies, Temporary Duty Travel (TDY), etc. Each of these categories falls under the overarching Operations and Maintenance (O&M) appropriation.

The office responsible for conducting an A-76 study, Manpower (MO), currently falls under the Mission Support Squadron (MSS) of the Wing being studied. Cost data related to the A-76 study were accomplished and supplied by the MO office. Data requiring analysis provided by MO was a synopsis of the costs to the government if the Most Efficient Organization were to accomplish the work using 100% government personnel and assets, in other words, no work activities contracted out to a third party. MO also provided much of the cost comparison data since they are responsible for accomplishing the A-76 study. Therefore, their comparison data also included costs that would be incurred by the government if the operations are contracted out. These comparative costs for the contract are summarized numbers showing the total costs in broad categories, with the specifics for the costs embedded within the contract itself.

A third office, the Contracting Squadron (CONS), is responsible for soliciting, negotiating, and finally awarding the contract, if it provides the requisite cost savings to the government. The CONS within the Wing provided the more detailed information regarding the costs embedded within the broad categories of the contract. The somewhat detailed information describing the service to be provided and the costs associated with it is contained within the various contracting documents and their modifications. In-depth information is considered proprietary and therefore not available for this analysis.

Finally, the most recently released inflation factors (dated 20 January 2006) for normalizing the data to a constant year were obtained through the office of the Deputy Assistant Secretary of the Air Force for Cost and Economics (SAF/FMC). Provided annually for cost analyses, the inflation factors allow for the normalization of cost data from one year to another and are broken down by major cost categories. These inflation factors allow analysis of a particular cost category, such as civilian pay, by taking into account the effects of inflation from one year to the next. In other words, civilian pay

costs covering a number of fiscal years can all be converted to a constant value of one particular year, allowing a comparison of apples to apples and showing true cost growth or decreases.

C. METHODOLOGY OF ANALYSIS

1. Overview

Using the data provided by the various units mentioned earlier, three methods of analysis are used to help determine whether or not the Air Force saved money by outsourcing supply functions at the base being studied. These three cost comparison methods are as follows:

1) Compare the Actual Annual Costs prior to outsourcing with the Actual Annual Costs after outsourcing

2) Compare the Actual Annual Costs after outsourcing to a estimate of what it would have cost to maintain the operations as-is

3) Compare the Actual Annual Costs after outsourcing versus the Anticipated Annual Costs of the contract as determined in the outsourcing process

Each of these methods of analysis will provide a slightly different perspective on whether the Air Force achieved the cost savings sought through the outsourcing process. An assumption being made, which allows for a more simplified analysis of this outsourcing action, is that the military personnel costs are not going away. Mentioned earlier in Chapter II, outsourcing competitions do not necessarily result in a decrease in military positions¹⁸⁹. Therefore, military personnel costs are not included as part of this analysis for either costs savings achieved through their elimination or their costs incurred by re-training and shuffling to another function. In the end, military personnel costs are irrelevant since it is most likely that they will simply be shuffled from the function being outsourced to another area (not necessarily at the same base), thus resulting in no true cost savings. Savings in military positions seem to occur for the base since the positions come off the Wing's roster of military positions. These same military members,

¹⁸⁹ Susan M. Gates, and Albert A. Robbert. Personnel Savings in Competitively Sourced DoD Activities: Are they Real? Will they Last?. RAND, 2000.

however, have enlistments and commissions which have to be honored like a contract itself and leads to their reassignments elsewhere within the Air Force.

a. Pre-Outsourcing Actual Annual Costs versus Post-Outsourcing Actual Annual Costs

Comparing and analyzing the pre-outsourcing actual annual costs with the post-outsourcing actual annual costs is likely the easiest of the three methods being used to determine whether or not the Air Force saved money by outsourcing this particular supply squadron. This analysis will look at the costs associated with the supply squadron both with the effects of inflation (nominal cost growth) and with inflation factored in (real cost growth). The analysis will then compare the obligations incurred one year to the obligations of another. Obviously, common sense in the analysis provides that if there is a decrease in obligations from a previous year to a future year, funds were saved and the outsourcing at least partially achieved its goal. To determine whether or not outsourcing met the overall goal of saving money for the Air Force, the entire time period studied for outsourcing competition must be considered, but historical data from the prior ten years will also provide some insight to the trends occurring at the time of the outsourcing. Table 1 summarizes the nominal costs to be compared and analyzed against one another:

Summary of Pre-outsourcing Actual Annual Costs (FY91-FY00) and Post-outsourcing Actual Annual Costs (FY01-FY05)

	<u>FY91</u>	<u>FY92</u>	<u>FY93</u>	<u>FY94</u>	<u>FY95</u>
Civilian Pay: \$	412,720	\$ 1,858,609	\$ 1,933,273	\$ 1,833,875	\$ 1,864,373
Fuels: \$	34,731	\$ 41,991	\$ 45,496	\$ 51,186	\$ 44,393
All other Operations and Maintenance: \$	660,908	\$ 439,564	\$ 1,020,972	\$ 605,150	\$ 515,082
Total: \$	1,108,359	\$ 2,340,164	\$ 2,999,741	\$ 2,490,211	\$ 2,423,848

	<u>FY96</u>	<u>FY97</u>	<u>FY98</u>	<u>FY99</u>	<u>FY00</u>
Civilian Pay: \$	1,849,685	\$ 1,916,831	\$ 2,034,485	\$ 1,848,854	\$ 1,848,860
Fuels: \$	45,905	\$ 53,101	\$ 59,460	\$ 65,710	\$ 44,005
All other Operations and Maintenance: \$	465,413	\$ 611,246	\$ 976,383	\$ 441,661	\$ 534,022
Total: \$	2,361,003	\$ 2,581,178	\$ 3,070,328	\$ 2,356,225	\$ 2,426,887

	<u>FY01</u>	<u>FY02</u>	<u>FY03</u>	<u>FY04</u>	<u>FY05</u>
Civilian Pay: \$	1,582,258	\$ 3,657	\$ -	\$ -	\$ -
Fuels: \$	61,761	\$ 3,299	\$ 7,183	\$ 8,858	\$ 11,134
All other Operations and Maintenance: \$	1,403,175	\$ 3,631,431	\$ 4,147,795	\$ 4,979,256	\$ 5,773,928
Total: \$	3,047,194	\$ 3,638,387	\$ 4,154,978	\$ 4,988,114	\$ 5,785,062

Table 1. Summary of Pre-outsourcing Actual Annual Costs (FY91-FY00) and Post-outsourcing Actual Annual Costs (FY01-FY05)

The methods for adjusting the above nominal costs to real costs will be discussed in the next section since it is the sole basis for the analysis there.

b. Post-Outsourcing Actual Annual Costs versus Estimated Cost to Have Remained “In-House”

Post-outsourcing actual annual costs will be compared to the estimated cost to have remained “in-house” by incorporating the SAF/FMC inflation factors, thereby providing real cost growth (versus nominal). This method of analysis will compare the actual annual cost after the outsourcing action to the cost it would have likely cost the Air Force to have simply allowed the squadron to continue operating as-is with the annual obligations simply keeping up with inflation. For this comparison, Fiscal Year 2000 will be the year all the numbers are normalized to since this corresponds to the last full fiscal year with no outsourcing costs associated. Cost categories will be broken into three areas for which cost data was provided and for which there are inflation indices specifically for these areas: Civilian Pay, Fuels, and Other Operations and Maintenance.

Comparing costs in these categories offers the most visible way to see if funds were saved since it all pertains to transactions visible and under the control of the budget office for the function being outsourced.

Inflation indices for the categories above are summarized in Table 2:

Conversion Factors to Constant FY 2000 Dollars (rounded to nearest .001)					
	<u>FY91</u>	<u>FY92</u>	<u>FY93</u>	<u>FY94</u>	<u>FY95</u>
Civilian Pay:	0.742	0.773	0.803	0.829	0.853
Fuels:	1.328	1.131	1.147	1.309	1.146
All other Operations and Maintenance:	0.850	0.874	0.898	0.916	0.933
	<u>FY96</u>	<u>FY97</u>	<u>FY98</u>	<u>FY99</u>	<u>FY00</u>
Civilian Pay:	0.876	0.900	0.926	0.957	1.000
Fuels:	1.211	1.226	1.468	1.339	1.000
All other Operations and Maintenance:	0.952	0.972	0.978	0.986	1.000
	<u>FY01</u>	<u>FY02</u>	<u>FY03</u>	<u>FY04</u>	<u>FY05</u>
Civilian Pay:	1.040	1.085	1.131	1.178	1.221
Fuels:	1.629	1.613	1.355	1.467	1.951
All other Operations and Maintenance:	1.018	1.026	1.036	1.057	1.087

Table 2. Conversion Factors to Constant FY 2000 Dollars

To illustrate how these indices are used, assume there is \$100 in Civilian Pay allocated in FY00. In order to keep up with inflation within the Civilian Pay account, the \$100 in FY00 will have the same value as \$104.02 in FY01 ($\$100 * 1.040 = \104.00). Likewise, an example working backwards is given. Assume there is \$100 in FY03 dollars in the Civilian Pay account and it is desired to know what it is worth in FY00 dollars. The resulting value in FY00 dollars is \$88.39 ($\$100/1.131 = \88.42). Doing these calculations for the cost data provided allows us to compare constant dollars across the board. In this case, it will be constant FY00 dollars.

Table 3 shows the estimated real costs, in terms of both historic and future years (Constant FY00 dollars), with FY00 as the baseline:

Estimated Costs for Past and Future Based on FY00 data (In FY00 \$)

	<u>FY91</u>	<u>FY92</u>	<u>FY93</u>	<u>FY94</u>	<u>FY95</u>	<u>FY96</u>	<u>FY97</u>	<u>FY98</u>
Civilian Pay (FY00 Base Rate):	\$ 1,848,860	\$ 1,848,860	\$ 1,848,860	\$ 1,848,860	\$ 1,848,860	\$ 1,848,860	\$ 1,848,860	\$ 1,848,860
Civilian Pay Inflation Multiplier:	0.742	0.773	0.803	0.829	0.853	0.876	0.900	0.926
Civilian Pay Required In Particular								
Fiscal Years (FY00 \$):	\$ 1,371,670	\$ 1,428,882	\$ 1,483,851	\$ 1,532,640	\$ 1,577,899	\$ 1,618,688	\$ 1,664,772	\$ 1,712,351
Fuels (FY00 Base Rate):	\$ 44,005	\$ 44,005	\$ 44,005	\$ 44,005	\$ 44,005	\$ 44,005	\$ 44,005	\$ 44,005
Fuels Inflation Multiplier:	1.328	1.131	1.147	1.309	1.146	1.211	1.226	1.468
Fuels Funding Required In Particular								
Fiscal Years (FY00 \$):	\$ 58,419	\$ 49,773	\$ 50,470	\$ 57,586	\$ 50,445	\$ 53,270	\$ 53,963	\$ 64,593
All other Operations and Maintenance								
(FY00 Base Rate):	\$ 534,022	\$ 534,022	\$ 534,022	\$ 534,022	\$ 534,022	\$ 534,022	\$ 534,022	\$ 534,022
All other Operations and								
Maintenance Inflation Multiplier:	0.850	0.874	0.898	0.916	0.933	0.952	0.972	0.978
All other Operations and Maintenance								
Funding Required In Particular Fiscal								
Years (FY00 \$):	\$ 454,012	\$ 466,724	\$ 479,326	\$ 488,912	\$ 498,202	\$ 508,166	\$ 518,837	\$ 522,469
Total Funds Required (FY00 \$):	\$ 1,884,101	\$ 1,945,379	\$ 2,013,647	\$ 2,079,139	\$ 2,126,546	\$ 2,180,124	\$ 2,237,572	\$ 2,299,414

Estimated Costs for Past and Future Based on FY00 data (In FY00 \$) Continued

	<u>FY99</u>	<u>FY00</u>	<u>FY01</u>	<u>FY02</u>	<u>FY03</u>	<u>FY04</u>	<u>FY05</u>
Civilian Pay (FY00 Base Rate):	\$ 1,848,860	\$ 1,848,860	\$ 1,848,860	\$ 1,848,860	\$ 1,848,860	\$ 1,848,860	\$ 1,848,860
Civilian Pay Inflation Multiplier:	0.957	1.000	1.040	1.085	1.131	1.178	1.221
Civilian Pay Required In Particular							
Fiscal Years (FY00 \$):	\$ 1,770,023	\$ 1,848,860	\$ 1,923,129	\$ 2,006,612	\$ 2,091,752	\$ 2,177,514	\$ 2,257,451
Fuels (FY00 Base Rate):	\$ 44,005	\$ 44,005	\$ 44,005	\$ 44,005	\$ 44,005	\$ 44,005	\$ 44,005
Fuels Inflation Multiplier:	1.339	1.000	1.629	1.613	1.355	1.467	1.951
Fuels Funding Required In Particular	\$ 58,909	\$ 44,005	\$ 71,684	\$ 70,967	\$ 59,613	\$ 64,560	\$ 85,865
Fiscal Years (FY00 \$):							
All other Operations and Maintenance							
(FY00 Base Rate):	\$ 534,022	\$ 534,022	\$ 534,022	\$ 534,022	\$ 534,022	\$ 534,022	\$ 534,022
All other Operations and							
Maintenance Inflation Multiplier:	0.986	1.000	1.018	1.026	1.036	1.057	1.087
All other Operations and Maintenance							
Funding Required In Particular Fiscal							
Years (FY00 \$):	\$ 526,649	\$ 534,022	\$ 543,634	\$ 547,983	\$ 553,463	\$ 564,533	\$ 580,339
Total Funds Required (FY00 \$):	\$ 2,355,581	\$ 2,426,887	\$ 2,538,447	\$ 2,625,562	\$ 2,704,828	\$ 2,806,607	\$ 2,923,655

Table 3. Estimated Costs for Past and Future Based on FY00 data

Table 3 allows the comparison of both future and historic years to a common baseline. Furthermore, it can also show the future growth compared to what “should have been” and to the historic actual to highlight any large deviations from history. In order to provide a basis for comparison of “apples to apples,” Table 4 gives the calculations for the post-outsourcing actual annual costs adjusted for inflation to provide numbers that are given in FY00 dollars:

Actual Annual Costs in FY 00 Dollars								
	<u>FY91</u>	<u>FY92</u>	<u>FY93</u>	<u>FY94</u>	<u>FY95</u>	<u>FY96</u>	<u>FY97</u>	<u>FY98</u>
Actual Civilian Pay: \$	412,720	\$ 1,858,609	\$ 1,933,273	\$ 1,833,875	\$ 1,864,373	\$ 1,849,685	\$ 1,916,831	\$ 2,034,485
Civilian Pay Inflation Multiplier:	0.742	0.773	0.803	0.829	0.853	0.876	0.900	0.926
Civilian Pay Required In Future Years (FY00 \$):	\$ 556,301	\$ 2,404,892	\$ 2,408,834	\$ 2,212,246	\$ 2,184,528	\$ 2,112,704	\$ 2,128,791	\$ 2,196,674
Actual Fuel Cost: \$	34,731	\$ 41,991	\$ 45,496	\$ 51,186	\$ 44,393	\$ 45,905	\$ 53,101	\$ 59,460
Fuels Inflation Multiplier:	1.328	1.131	1.147	1.309	1.146	1.211	1.226	1.468
Fuels Funding Required In Future Years (FY00 \$):	\$ 26,162	\$ 37,125	\$ 39,669	\$ 39,115	\$ 38,726	\$ 37,921	\$ 43,302	\$ 40,508
All other Operations and Maintenance Costs: \$	660,908	\$ 439,564	\$ 1,020,972	\$ 605,150	\$ 515,082	\$ 465,413	\$ 611,246	\$ 976,383
All other Operations and Maintenance Inflation Multiplier:	0.850	0.874	0.898	0.916	0.933	0.952	0.972	0.978
All other Operations and Maintenance Funding Required In Future Years (FY00 \$):	\$ 777,379	\$ 502,945	\$ 1,137,476	\$ 660,984	\$ 552,116	\$ 489,094	\$ 629,135	\$ 997,973
Total Funds Required (FY00 \$):	\$ 1,359,842	\$ 2,944,963	\$ 3,585,978	\$ 2,912,345	\$ 2,775,369	\$ 2,639,719	\$ 2,801,229	\$ 3,235,155
Actual Annual Costs in FY 00 Dollars Continued								
	<u>FY99</u>	<u>FY00</u>	<u>FY01</u>	<u>FY02</u>	<u>FY03</u>	<u>FY04</u>	<u>FY05</u>	
Actual Civilian Pay: \$	1,848,854	\$ 1,848,860	\$ 1,582,258	\$ 3,657	\$ -	\$ -	\$ -	
Civilian Pay Inflation Multiplier:	0.957	1.000	1.040	1.085	1.131	1.178	1.221	
Civilian Pay Required In Future Years (FY00 \$):	\$ 1,931,202	\$ 1,848,860	\$ 1,521,153	\$ 3,370	\$ -	\$ -	\$ -	
Actual Fuel Cost: \$	65,710	\$ 44,005	\$ 61,761	\$ 3,299	\$ 7,183	\$ 8,858	\$ 11,134	
Fuels Inflation Multiplier:	1.339	1.000	1.629	1.613	1.355	1.467	1.951	
Fuels Funding Required In Future Years (FY00 \$):	\$ 49,085	\$ 44,005	\$ 37,913	\$ 2,046	\$ 5,302	\$ 6,038	\$ 5,706	
All other Operations and Maintenance Costs: \$	441,661	\$ 534,022	\$ 1,403,175	\$ 3,631,431	\$ 4,147,795	\$ 4,979,256	\$ 5,773,928	
All other Operations and Maintenance Inflation Multiplier:	0.986	1.000	1.018	1.026	1.036	1.057	1.087	
All other Operations and Maintenance Funding Required In Future Years (FY00 \$):	\$ 447,844	\$ 534,022	\$ 1,378,364	\$ 3,538,910	\$ 4,002,097	\$ 4,710,149	\$ 5,313,105	
Total Funds Required (FY00 \$):	\$ 2,428,132	\$ 2,426,887	\$ 2,937,431	\$ 3,544,325	\$ 4,007,399	\$ 4,716,186	\$ 5,318,811	

Table 4. Actual Annual Costs in FY 00 Dollars

The data in the preceding tables will be used in further analysis in the following chapter.

c. Post-Outsourcing Actual Annual Costs versus Anticipated Contractual Costs

The final method of analysis is to compare the anticipated contractual costs at the time of contract award to the costs actually incurred by the Air Force to the post-outsourcing actual annual costs. This method is straight-forward and simply compares the amount of the contract awarded to the obligations incurred by the government each year. Since the contract is a Firm Fixed Price (FFP) contract, theoretically the price is semi-solidly set at award. Furthermore, with a FFP contract the vast majority of risk is placed upon the contractor since the price to be paid by the government has been thoroughly negotiated and agreed upon. Cost increases are then supposed to be absorbed by the contract, so long as the work being requested by the government is contained within the contract. Work that is outside of the contract will require secondary negotiations and increased costs to the government. This analysis does not require the use of any of the cost data prior to the outsourcing, so it will be ignored. Table 5 shows the anticipated contract costs with no apparent estimate included in them for future inflation compared to the actual costs incurred over the period:

Anticipated Contract Costs versus Post-outsourcing Actual Annual Costs							
	<u>FY01 (2 months</u>						
	<u>transition-Jun/Jul + 2</u>						
	<u>months-Aug/Sep)</u>	<u>FY02</u>	<u>FY03</u>	<u>FY04</u>	<u>FY05</u>	<u>Total</u>	
Anticipated Contract							
Costs: \$	1,241,801.89	\$ 3,570,300.26	\$ 3,575,999.22	\$ 3,575,999.22	\$ 3,575,999.22	\$	15,540,099.81
Actual Contract Costs: \$	1,237,146.00	\$ 3,628,830.00	\$ 4,147,795.00	\$ 4,979,256.00	\$ 5,773,928.00	\$	19,766,955.00
Difference: \$	4,655.89	\$ (58,529.74)	\$ (571,795.78)	\$ (1,403,256.78)	\$ (2,197,928.78)	\$	(4,226,855.19)

Table 5. Anticipated Contract Costs versus Post-outsourcing Actual Annual Costs

There is one important item to note when comparing Table 5 to Table 1. From Table 1, the category “All other Operations and Maintenance” for years FY01 to FY05 is composed entirely of contract costs. These numbers then directly translate to the “Actual

Contract Costs” in Table 5, indicating that there are no additional costs in the “All other Operations and Maintenance” category of Table 1 combined with the contract costs which would require separation prior to any analysis.

IV. ANALYSIS

A. ANALYSIS OF COSTS OF OUTSOURCING

1. Summary of Outsourcing Results as Conducted through the A-76 Process

Before going straight into comparing and analyzing costs in the manner described in the previous chapter, it is probably useful to provide a background of the actual A-76 competition results that are now the subject of our scrutiny. Since the majority of the cost comparison data used in an A-76 competition revolves around personnel costs, our background will use this as a starting point. The supply squadron being outsourced had 208 total DoD positions that were outsourced, consisting of seven officers, 168 enlisted personnel, and 33 civilians. Through the A-76 study, it was determined that the MEO for the government would consist of 97.75 full-time equivalent civilians. From the documents disclosed, it was not apparent how many personnel the winning contractor would be using to fulfill the workload, as this would be too detailed and considered proprietary information.

As a result of the A-76 competition, the MEO had an estimated cost of \$28,620,082 over the period of time considered. Over the same period of time, the contract price determined in the competition was estimated to have a cost of \$16,630,702. A minimum conversion differential of \$2,422,751, which is equivalent to 10% of the MEO's personnel costs, was added to the estimated contract cost to give an adjusted total cost of \$19,053,453. This adjusted total cost of the contract is what is compared to the MEO cost to determine cost savings, in this case the savings were estimated at \$9,566,629 (\$28,620,082 - \$19,053,453). Since the cost savings are positive with the 10% of the MEO's personnel costs already considered, the contractor won the competition for exceeding the 10% threshold (and nearly the \$10 million threshold as well) within the competition's rules. After the competition decision, other apparent cost savings within the contract appeared to be realized as the total amount of the FFP contract came in at \$15,540,099.81 instead of the projected \$16,630,702. The contract cost was then spread out nearly evenly over the period of performance (see Table 5 in

Chapter III, Section 4 for the exact spread of contract costs) indicating no inflation effects in the future years. Many of the factors involved in calculating both the MEO cost and the winning contract cost, as provided for in the A-76 guidelines, will be scrutinized more in the following sections.

2. Pre-Outsourcing Actual Annual Costs versus Post-Outsourcing Actual Annual Costs

a. Nominal Cost Analysis

By looking at the data it is very apparent that there were significant increases in the amount of Air Force funding spent on the supply squadron being studied after the outsourcing occurred. The nominal cost data will be first in this analysis and is reflected again to provide a convenient source for review as follows in Table 6:

Summary of Pre-outsourcing Actual Annual Costs (FY91-FY00) and Post-outsourcing Actual Annual Costs (FY01-FY05)						
	<u>FY91</u>	<u>FY92</u>	<u>FY93</u>	<u>FY94</u>	<u>FY95</u>	
Civilian Pay: \$	412,720	\$ 1,858,609	\$ 1,933,273	\$ 1,833,875	\$ 1,864,373	
Fuels: \$	34,731	\$ 41,991	\$ 45,496	\$ 51,186	\$ 44,393	
All other Operations and Maintenance: \$	660,908	\$ 439,564	\$ 1,020,972	\$ 605,150	\$ 515,082	
Total: \$	1,108,359	\$ 2,340,164	\$ 2,999,741	\$ 2,490,211	\$ 2,423,848	
	<u>FY96</u>	<u>FY97</u>	<u>FY98</u>	<u>FY99</u>	<u>FY00</u>	
Civilian Pay: \$	1,849,685	\$ 1,916,831	\$ 2,034,485	\$ 1,848,854	\$ 1,848,860	
Fuels: \$	45,905	\$ 53,101	\$ 59,460	\$ 65,710	\$ 44,005	
All other Operations and Maintenance: \$	465,413	\$ 611,246	\$ 976,383	\$ 441,661	\$ 534,022	
Total: \$	2,361,003	\$ 2,581,178	\$ 3,070,328	\$ 2,356,225	\$ 2,426,887	
	<u>FY01</u>	<u>FY02</u>	<u>FY03</u>	<u>FY04</u>	<u>FY05</u>	
Civilian Pay: \$	1,582,258	\$ 3,657	\$ -	\$ -	\$ -	
Fuels: \$	61,761	\$ 3,299	\$ 7,183	\$ 8,858	\$ 11,134	
All other Operations and Maintenance: \$	1,403,175	\$ 3,631,431	\$ 4,147,795	\$ 4,979,256	\$ 5,773,928	
Total: \$	3,047,194	\$ 3,638,387	\$ 4,154,978	\$ 4,988,114	\$ 5,785,062	

Table 6. Summary of Pre-outsourcing Actual Annual Costs (FY91-FY00) and Post-outsourcing Actual Annual Costs (FY01-FY05)

At first look, the ten years prior to outsourcing (FY91-FY00) had some variability to the costs associated with the supply squadron from year to year. To further illustrate this, Figure 4 shows the costs over the entire range from FY91-FY05:

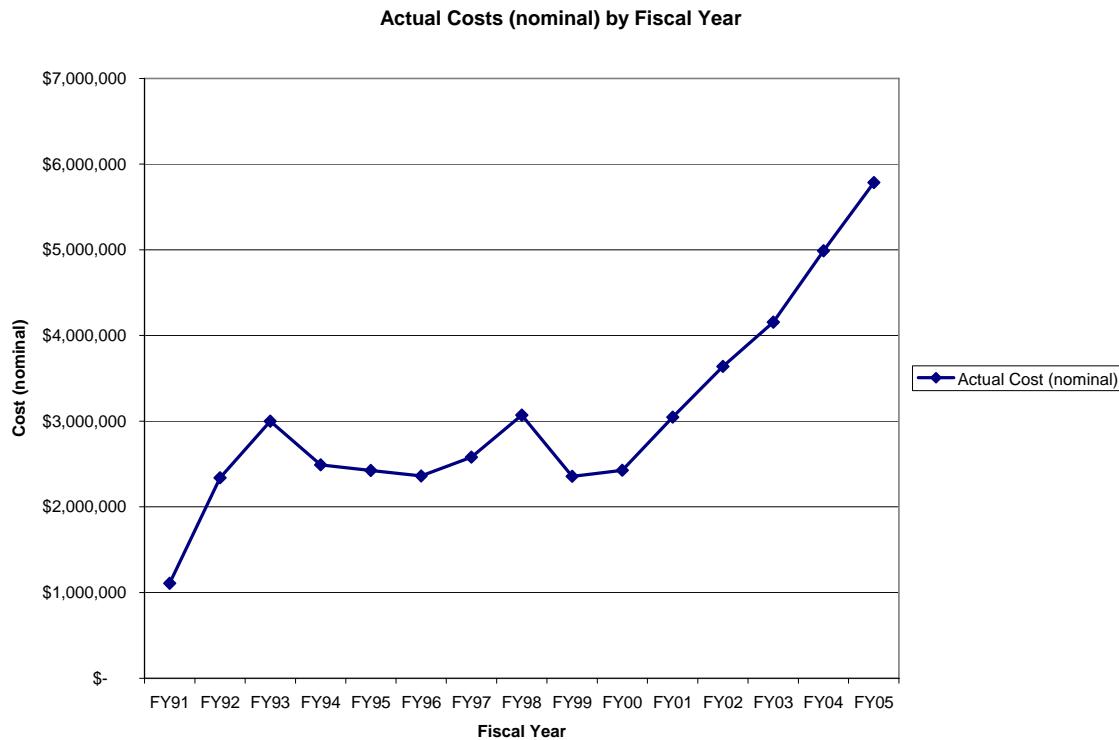


Figure 4. Actual Costs (nominal) by Fiscal Year

Despite the obvious variability, the casual observer can conclude that more often than not, a cost of about \$2.5 million could have been assumed for the squadron prior to outsourcing. Doing the necessary statistical calculations on the first ten years, the data provides a mean cost of \$2,415,794 and a median cost of \$2,425,368 proving the initial estimate of \$2.5 million is not very far off the mark. Furthermore, the median is within \$2,000 of the FY00 actual costs and should support the use of that year as a basis for comparison. Figure 4 shows the very apparent increase in nominal costs in the years after outsourcing, FY01-FY05.

Looking further at the numbers provided in Table 6, it is readily apparent that the annual costs associated with the supply squadron more than doubled within five years from the time it was outsourced in FY00. Further calculations show the actual

amount of funding required for the supply squadron increased by 138% within the first five years of being outsourced. Using compounded interest over the five years, this would equate to an average annual increase of 18.97% per year. This growth greatly exceeds the growth rate of 3% most people typically use to estimate inflation. If the supply squadron had simply kept up with inflation over the next five years (calculated in a compounding manner), FY05 would only have required \$2,813,427 to run operations as they were in FY00. From this simple look at the pre-outsourcing actual annual costs compared to the post-outsourcing actual annual costs, it is seen that outsourcing this supply squadron did not necessarily save the Air Force any money.

Looking more closely at the numbers associated with the contract itself, it may be beneficial to compare the increases from year to year. This analysis should provide insight to any trends or to determine if the largest increases were later in the contract versus earlier on. Using FY00 as a baseline figure because it is the last full year prior to the associated outsourcing costs, Table 7 provides the calculations showing cost increases each year for the supply squadron:

Increases in Funding Required from Year to Year							
	<u>FY00</u>	<u>FY01</u>	<u>FY02</u>	<u>FY03</u>	<u>FY04</u>	<u>FY05</u>	<u>Arithmetic Mean of Cost Growth</u>
Total:	\$ 2,426,887.00	\$ 3,047,194.00	\$ 3,638,387.00	\$ 4,154,978.00	\$ 4,988,114.00	\$ 5,785,062.00	
Cost Increase from Prior							
Year:		\$ 620,307.00	\$ 591,193.00	\$ 516,591.00	\$ 833,136.00	\$ 796,948.00	
Percentage Increase							
from Prior Year:		25.6%	19.4%	14.2%	20.1%	16.0%	19.04%

Table 7. Increases in Funding Required from Year to Year

From the above calculations, the largest increase from one year to the next was from FY00 to FY01. The most probable explanation for the large *percentage* increase in FY01 is likely due to the transition from government operations to contractor operations compared to a smaller baseline figure. The contract for the operations of the supply squadron became effective for the last four months of FY01, which at first look really make one wonder how much the government was going to lose due to this

outsourcing process. It is important to keep in mind that over the four month period, there are essentially twice as many people on hand for the squadron as normal so there is the necessary turnover and training taking place to allow as minimal an impact upon the rest of the base as possible. This duplication of personnel is further explained by simply looking at the civilian pay costs in Table 6 and noting the decreased costs from FY00-FY02 as the civilians on the books are phased out.

Later *nominal* increases are much larger in scope than that for FY01, but do not provide the large percentage changes because the prior year's baseline has become larger due to the increases in that particular year. The end result of all of these increases is a compounding of costs increases, which is akin to the compounding effect of interest on a loan or investment. This compounding effect provides cost growth that is linear by nature. Table 8 summarizes the cumulative effect of the cost growth based on the nominal costs:

Cumulative Effect of Cost Growth FY00-FY05						
	<u>FY00</u>	<u>FY01</u>	<u>FY02</u>	<u>FY03</u>	<u>FY04</u>	<u>FY05</u>
Actual Costs	\$ 2,426,887	\$ 3,047,194	\$ 3,638,387	\$ 4,154,978	\$ 4,988,114	\$ 5,785,062
Baseline Costs (FY00)	\$ 2,426,887	\$ 2,426,887	\$ 2,426,887	\$ 2,426,887	\$ 2,426,887	\$ 2,426,887
Delta	\$ -	\$ 620,307	\$ 1,211,500	\$ 1,728,091	\$ 2,561,227	\$ 3,358,175
Cumulative Cost Growth	0.0%	25.6%	49.9%	71.2%	105.5%	138.4%

Table 8. Cumulative Effect of Cost Growth FY00-FY05

Placing the information from Table 8 in graphical format, Figure 5 emerges as follows:

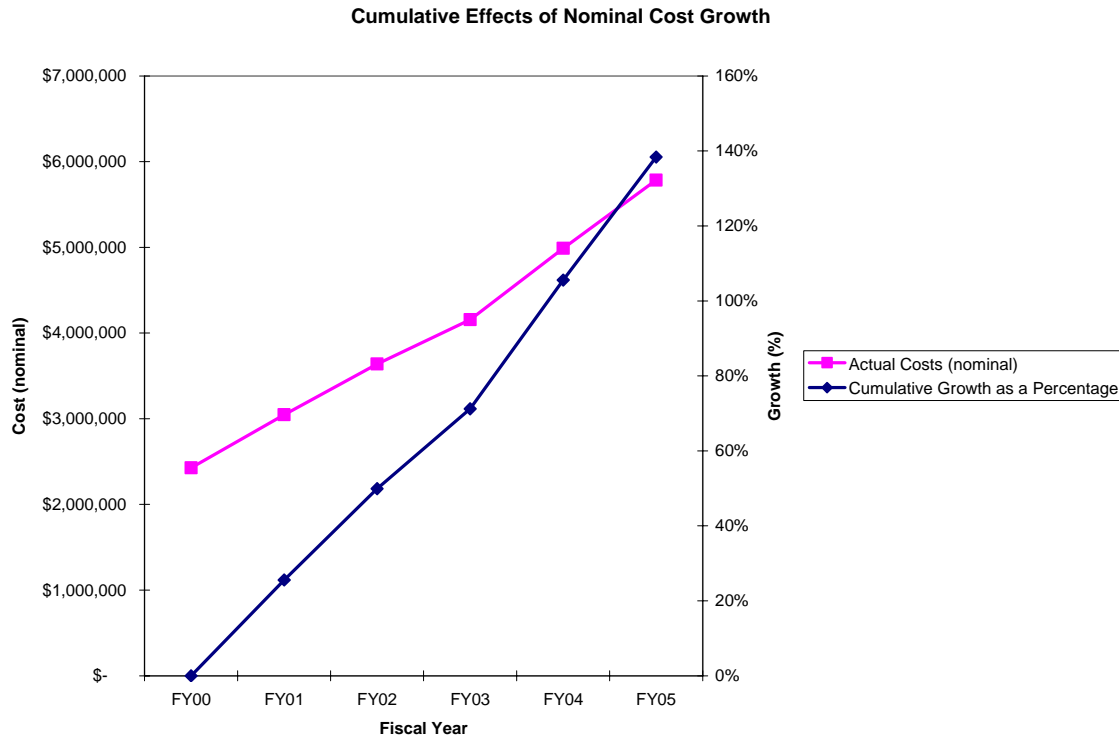


Figure 5. Cumulative Effects of Nominal Cost Growth

The increases in cost growth for FY00-FY05 provided an arithmetic average of 19.0%, which is very close to the compounded rate found earlier of 18.97%. Fortunately, there seems to be no real exponential increases in cost growth indicating a contractor who may have determined how to take advantage of the government in a legal manner and acted on it. However, there is the constant increase in costs from year to year after the contract was awarded which greatly exceeds most reasonable expectations which could be explained by simple inflation. By comparing the pre-outsourcing actual annual costs to the post-outsourcing actual annual costs in nominal terms, it is reasonable to conclude the Air Force did not reap the savings they anticipated.

b. Real Cost Analysis

To solidify whether or not the Air Force saved funds in the post-outsourcing timeframe, nominal costs provide a start but are not necessarily the best for analysis. Inflation does occur and it actually occurs somewhat differently across and

within various appropriations of the federal government. The calculations for adjusting the nominal costs to real have already been accomplished in Chapter III and are summarized in Table 9:

Actual Annual Costs in FY 00 Dollars

Fiscal Year	Actual Real Costs Incurred (FY00 \$)
FY91 \$	1,359,842
FY92 \$	2,944,963
FY93 \$	3,585,978
FY94 \$	2,912,345
FY95 \$	2,775,369
FY96 \$	2,639,719
FY97 \$	2,801,229
FY98 \$	3,235,155
FY99 \$	2,428,132
FY00 \$	2,426,887
FY01 \$	2,937,431
FY02 \$	3,544,325
FY03 \$	4,007,399
FY04 \$	4,716,186
FY05 \$	5,318,811

Table 9. Actual Annual Costs in FY 00 Dollars

The costs from the table above, normalized for inflation, show somewhat more volatility from year to year as compared to the nominal costs previously analyzed. This volatility, along with the deviation from the FY00 baseline as a percentage, can be seen in Figure 6:

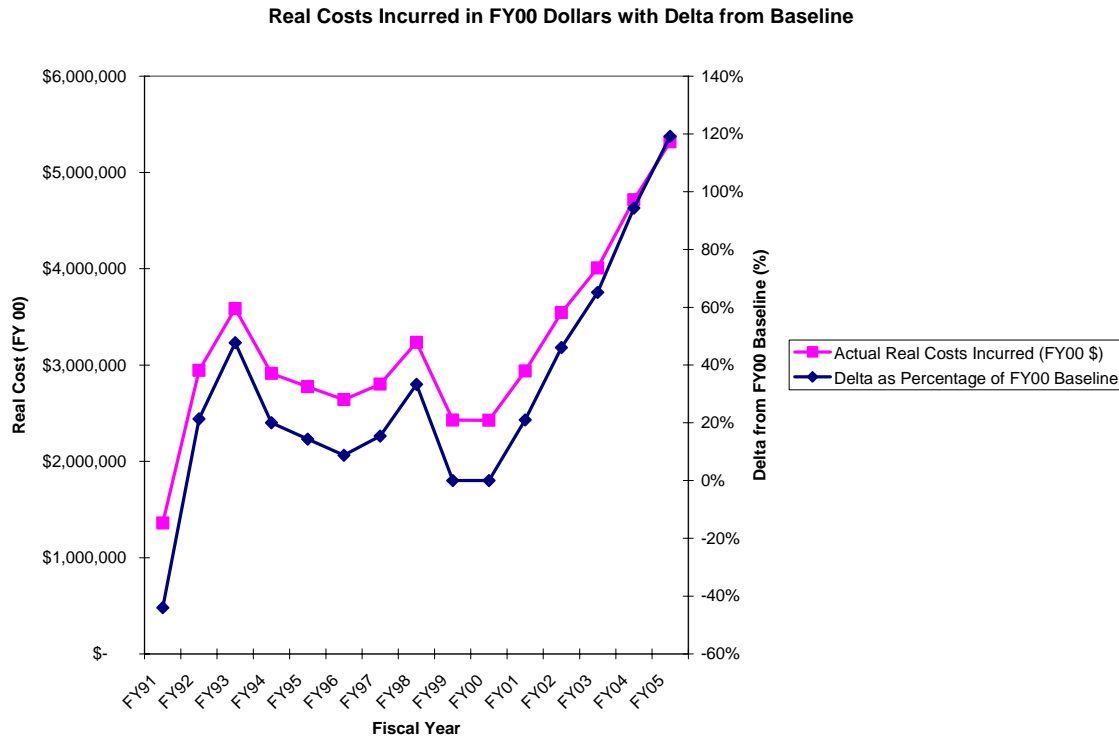


Figure 6. Real Costs Incurred in FY00 Dollars with Delta from Baseline

Figure 6 shows an interesting trend in the real costs prior to outsourcing: in general, the costs associated with the supply squadron were decreasing over time. The spike from FY91 to FY92 and FY93 can likely be explained by increased costs due to Operation Desert Storm. Following this increase, there are several years of decreases from FY94-FY96 which are probably attributable to the budget cuts of President Clinton’s Administration. The next two fiscal years, FY97 and FY98, show modest gains followed by further budget cutting in FY99 and FY00. The years following these two fiscal years, FY01-FY05, show significant increases year after year with potentially no end in sight for future increases. Of course, these fiscal years correspond to the same period of time the contract was in place for the operations of the supply squadron. While it is much easier to analyze data after-the-fact versus predicting the future, there are likely few models which would have shown the same magnitude of cost increases from FY01-FY05 had the government maintain operations “in-house.” Again, by looking at the pre-outsourcing actual annual costs to the post-outsourcing actual annual costs in real cost terms, it is reasonable to conclude the Air Force did not reap the savings they had

anticipated. An analysis of whether or not the Air Force could have reaped saving by keeping the operations “in-house” is the next approach which will be explored.

3. **Post-Outsourcing Actual Annual Costs versus Estimated Cost to Have Remained “In-House”**

A look at the real cost data will provide the next basis for analysis. Using the inflation factors as a guide for the inflation which would have occurred after FY00, we can compare what the supply squadron’s budget would have been if it had remained “in-house.” This can then be compared to the actual costs incurred over the period adjusted for inflation to bring all the data into constant FY00 dollars for a comparison of like costs. This data, as calculated in Chapter III, is provided in the following table:

Comparison of Estimated Cost to Remain "In-house" versus Post-outsourcing Actual Annual Costs (all figures in FY00 \$)							
	<u>FY00</u>	<u>FY01</u>	<u>FY02</u>	<u>FY03</u>	<u>FY04</u>	<u>FY05</u>	<u>Total</u>
Estimated "In-house" Total							
Funds Required: \$	2,426,887	\$ 2,538,447	\$ 2,625,562	\$ 2,704,828	\$ 2,806,607	\$ 2,923,655	\$ 16,025,987
Post-outsourcing Actual							
Annual Costs Incurred: \$	2,426,887	\$ 2,937,431	\$ 3,544,325	\$ 4,007,399	\$ 4,716,186	\$ 5,318,811	\$ 20,524,152
Delta: (Projected - Actual) \$	-	\$ 398,984	\$ 918,762	\$ 1,302,571	\$ 1,909,579	\$ 2,395,156	\$ 4,498,165
Percent Over Estimated							
Annual "In-house" Cost:	0.00%	15.72%	34.99%	48.16%	68.04%	81.92%	28.07%

Table 10. Comparison of Estimated Cost to Remain “In-house” versus Post-outsourcing Actual Annual Costs

From the information in Table 10, it is readily apparent that the post-outsourcing actual annual costs exceeded the estimated costs to have simply kept the supply squadron operating as-is, with all numbers normalized to a constant FY00 dollar. The divergence of the two estimates can be seen in Figure 7:

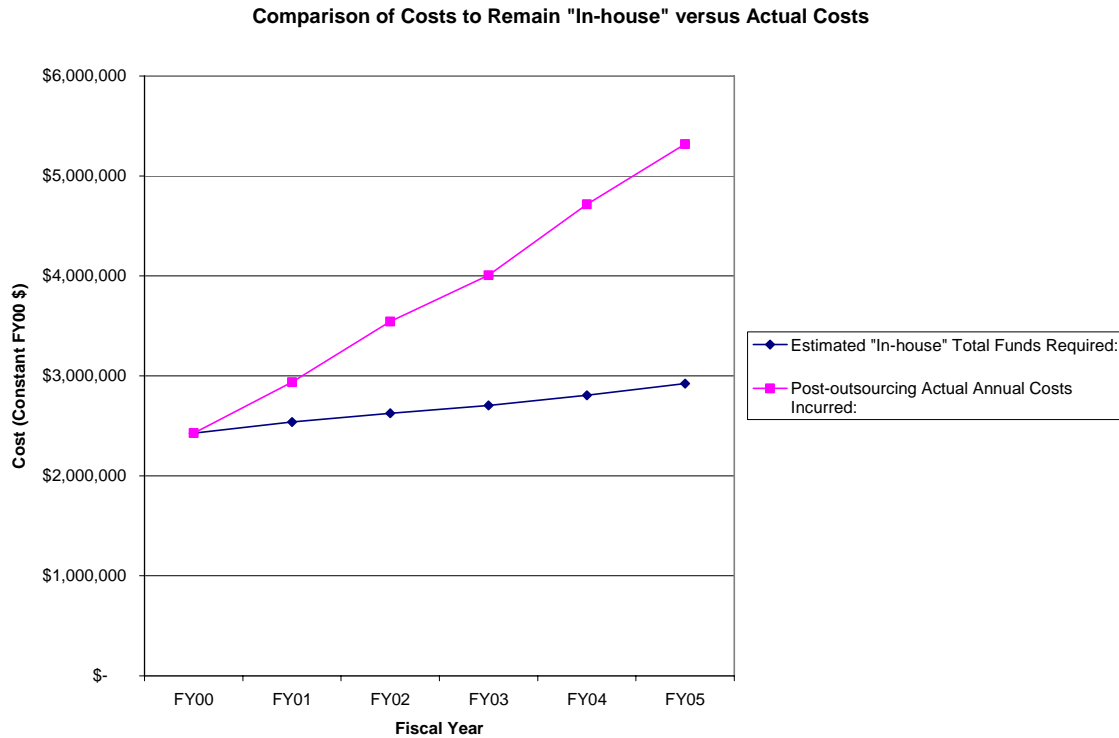


Figure 7. Comparison of Costs to Remain “In-house” versus Actual Costs

The growth over the period being studied was significant enough to lead to an overall cost growth of 28.07% over what the costs “should have been” had operations remained “in-house.” Figure 7 shows the effect of this actual cost growth, year after year, resulting in the large difference between the estimate and the actual cost growth.

Before going further, it is probably important to explain an assumption being made in these calculations. For this analysis, there is the assumption that the squadron’s costs increased by the historic inflation factors year after year. In actuality, it is extremely difficult to forecast what expenses would have been incurred by the unit. The world of budgeting at the base level could have caused a decrease in what was funded within the squadron from one year to the next due to a civilian position vacancy or an overall cut to all units’ discretionary budgets. On the other hand, some other independent variable within the unit may have arisen requiring significantly more funding than that projected. Despite the simplicity of the calculations being accomplished, there are many

factors that could have caused many different “actual” scenarios to be played out, but assumptions are necessary to provide a common ground for analysis.

Looking at the data in a similar manner to that of Section 2 above, it is possible to look at the cost growth from year to year for each of the two scenarios being analyzed within this section. Table 11 shows this analysis:

Increases in Funding Required from Year to Year (all numbers in constant FY00 \$)							<u>Arithmetic Mean</u>
	<u>FY00</u>	<u>FY01</u>	<u>FY02</u>	<u>FY03</u>	<u>FY04</u>	<u>FY05</u>	<u>of Cost Growth</u>
"In-house" Required funds:	\$ 2,426,887.00	\$ 2,538,447.25	\$ 2,625,562.50	\$ 2,704,828.10	\$ 2,806,607.05	\$ 2,923,655.43	
Cost Increase from Prior Year:		\$ 111,560.25	\$ 87,115.25	\$ 79,265.60	\$ 101,778.95	\$ 117,048.38	
Percentage Increase from Prior Year:		4.6%	3.4%	3.0%	3.8%	4.2%	3.80%
Actual Required funds:	\$ 2,426,887.00	\$ 2,937,431.16	\$ 3,544,324.87	\$ 4,007,399.27	\$ 4,716,186.20	\$ 5,318,810.99	
Cost Increase from Prior Year:		\$ 510,544.16	\$ 606,893.71	\$ 463,074.40	\$ 708,786.93	\$ 602,624.79	
Percentage Increase from Prior Year:		21.0%	20.7%	13.1%	17.7%	12.8%	17.05%

Table 11. Increases in Funding Required from Year to Year

From the calculations above, it is apparent that had the operations for the supply squadron remained “in-house,” the arithmetic mean of the cost growth would have been fairly close to the assumed 3.0% inflation mentioned in Section 2 above. Unfortunately, the actual costs incurred had growth rates that greatly exceeded those anticipated for having kept the operations “in-house.” Again, FY01 cost growth can be explained somewhat by the duplicity of personnel required during the transition phase. The cost growth that occurred in the later years will be explained in the next section. The final conclusion to be drawn is that the Air Force did not realize the cost savings they anticipated through outsourcing.

4. Post-Outsourcing Actual Annual Costs versus Anticipated Contractual Costs

Comparing the post-outsourcing actual annual costs to the anticipated annual costs provided in the awarded contract at the time of the outsourcing competition is likely the best comparison to make in order to explain cost increases seen in the previous two sections. From Chapter III, Table 12 shows the costs that were projected in the awarded contract compared against the actual costs that were accrued by the Financial Analysis office:

Initial Projected Contract Costs compared against Actual Obligations Incurred						
	<u>FY01*</u>	<u>FY02</u>	<u>FY03</u>	<u>FY04</u>	<u>FY05</u>	<u>Total</u>
Projected:	\$ 1,241,802	\$ 3,570,300	\$ 3,575,999	\$ 3,575,999	\$ 3,575,999	\$ 15,540,100
Actual:	\$ 1,237,146	\$ 3,628,830	\$ 4,147,795	\$ 4,979,256	\$ 5,773,928	\$ 19,766,955
Delta:	\$ (4,656)	\$ 58,530	\$ 571,796	\$ 1,403,257	\$ 2,197,929	\$ 4,226,855
(Projected - Actual)						
Percent Over/Under	-0.37%	1.64%	15.99%	39.24%	61.46%	27.20%

* Only includes the 2 months of transition in June and July, plus the 2 months of normal operations under the contract in August and September.

Table 12. Initial Projected Contract Costs compared against Actual Obligations Incurred

The first period of time, the last four months of Fiscal Year 2001 (FY01), is the only period in which the actual contract costs came in under projections. Interestingly, this was when the contract was new and had just been implemented. Each of the following years showed progressively larger deviations from the costs initially projected, with the final tally showing the actual costs of the contract exceeded initial projections by more than 27%.

a. *Reasons for Contract Cost Growth*

By looking somewhat deeper into the contracting documents, there seems to be four areas that led to the future cost growth: changes in the definition of requirements, mandatory future pay increases not factored in original contract combined with the implementation of a collective bargaining agreement, payments for an incentive program, and the increased scope of operations due to the attacks on September 11, 2001. For a starting point of contract analysis, the actual contracting documents show increases by fiscal year in Table 13:

Changes by fiscal year to Initial Projected Contract Costs

	<u>FY01*</u>	<u>FY02</u>	<u>FY03</u>	<u>FY04</u>	<u>FY05</u>	<u>Total</u>
Projected:	\$ 1,241,801.89	\$ 3,570,300.26	\$ 3,575,999.22	\$ 3,575,999.22	\$ 3,575,999.22	\$ 15,540,099.81
Increases:	\$ (8,134.53)	\$ 146,905.18	\$ 1,002,365.66	\$ 1,762,118.25	\$ 2,285,971.62	\$ 5,189,226.18
Revised Contract	\$ 1,233,667.36	\$ 3,717,205.44	\$ 4,578,364.88	\$ 5,338,117.47	\$ 5,861,970.84	\$ 20,729,325.99
Cost:						
Percent Increase in						
Contract:	-0.66%	4.11%	28.03%	49.28%	63.93%	33.39%

* Only includes the 2 months of transition in June and July, plus the 2 months of normal operations under the contract in August and September.

Table 13. Changes by fiscal year to Initial Projected Contract Costs

b. Cost Growth Due to September 11 Attacks

Given the period of time this contract was in effect, the initial reason most people would consider for cost increases would likely be the attacks on September 11, 2001. Surprisingly, of the four reasons mentioned above, the directly attributable cost increases due to the attacks was only \$16,693.90. This accounts for only 0.4% of the \$5,189,226.18 negotiated contract cost increases and would not have been forecasted within the A-76 outsourcing competition.

c. Cost Growth Due to Federal Incentive Program

The next largest increase in the contract over the period of performance was due to a federally funded incentive program. Particularly, starting in FY 03, the contractor either subcontracted or was supplied by an entity falling under the authority of the Indian Financing Act of 1974. As a result of the subcontract or supplier, the contractor running the supply squadron was entitled to additional compensation under Section 504 of 25 U.S.C. 1544. This entitlement under federal law caused the negotiated contract to increase by \$187,499.52, or 3.6% of the total increases over the period of performance.

d. Cost Growth Due to Defined Changes within Contract

As may be expected, changes to the contract over time caused deviations from the original estimated costs. Sometimes these changes were beneficial in that the government essentially obligated a larger amount of money than what the contractor ultimately billed. This money was later deobligated and could be seen as cost savings for

the government. Unfortunately, these deobligations did not outweigh the other changes within the contract that the government asked the contractor to perform. Such things as Operational Readiness Inspection support, gas mask serviceability testing, and adjustments to the buildings available for use to the contractor ultimately led to a net cost of \$341,776.65 to the government. This represents 6.6% of the total increases over the period the contract was in effect. Various changes to a contract, like the aforementioned examples, arise quite often and the government is nearly always going to be charged a fee for such changes.

e. Cost Growth Due to Mandatory Wage Increases

Up to this point only 10.6% of the cost increases over the period of the contract have been explained. The final category of cost increases, mandatory pay increases, make up the remaining 89.4%. This equates to \$4,640,256.11 in increased costs over the period of the contract and a nearly 30% increase from the original contract. Analysis of the contracting documents shows that the Air Force had to incorporate, by law, wage increases each year as determined by the Department of Labor's (DOL) Wage Determinations. This was further exacerbated in FY03 when the contractor underwent a collective bargaining agreement, which dictated somewhat higher wages than simply those required by the DOL. Based on the analysis of the proposed contract costs versus the actual costs incurred, the Air Force only realized savings of \$6,430,376 (\$28,620,082 - \$19,766,955 - \$2,422,751) when compared against the MEO estimate and factoring in the conversion differential in Section 1. This figure is \$3,136,253 less than the projected cost savings of \$9,566,629, meaning that only 67.2% of the projected costs savings were realized. The conclusion, based on these numbers, is that the Air Force did save money by outsourcing, but not nearly in the magnitude they had estimated.

5. Weaknesses Discovered within the A-76 Competition Cost Estimates

The idea that the Air Force did indeed save money by outsourcing via the A-76 procedures may be even more questionable once the process itself is analyzed. There are several key assumptions taken into account in order to calculate the comparable costs which may skew the results and over-inflate cost savings.

By noting the wage increases in the contract which occurred year after year, the first disparity in comparing costs within the competition arises. OMB Circular A-76 is very specific about ensuring inflation is factored into the MEO's cost estimate. Attachment C of the Circular specifically states: "These annual pay raise assumptions and inflation factors shall be used in an agency or a public reimbursable cost estimate for pay and non-pay categories of cost...¹⁹⁰". On the other hand, there is not nearly the emphasis in ensuring the contract proposal has inflationary factors for contract proposal wages included. The Circular only alludes to inflation for wages to be included in the contract proposal in one paragraph stating:

Inflation for wages and salaries of civilian positions and private sector service positions (often referred to as "labor escalation") is included in private sector cost proposals, agency cost estimates, and public reimbursable cost estimates based on the solicitation requirements for economic price adjustment for labor inflation¹⁹¹.

It is fairly obvious from the previous cost analysis of the contract that future wage increases due to inflation were not included. This is particularly obvious by observing that each of the option years (FY02-FY05) have basically the same amount of funding required from year to year (the exception being FY02 which is slightly less than the others) with no obvious cost growth. Getting into the MEO's cost estimate, however, the estimated wages for federal employees included the inflation factors spelled out within the A-76 procedures. Particular to this case, the lack of inflationary factors for the contract proposal's wage structure puts it at a significant cost advantage over the MEO. The base year's estimated annual personnel cost for the Air Force was \$5,404,175. If this cost was carried in a manner consistent with contract proposal's apparent wage structure neglecting inflation, it would cause a restated MEO decrease of \$1,710,112. This would provide a new MEO estimate of \$26,909,970 (\$28,620,082 - \$1,710,112) for use in the initial competition. Actual cost savings are not changed since inflation has been taken into account above with the contract costs (after the fact) and compared to the originally inflated MEO costs.

¹⁹⁰ Office of Management and Budget. Circular no. A-76, 1999.

¹⁹¹ Office of Management and Budget. Circular no. A-76, 1999.

Another area found to over-inflate the MEO estimate involves casualty and liability insurance. This disparity arises from the requirement for the contractor to have insurance to cover liabilities that may arise. On the other hand, the federal government is self-insured and doesn't actually pay for any insurance. The MEO estimate, however, is required to have an estimate for insurance cost despite the fact that they will never have to pay insurance. This self-insured aspect should be an inherent cost-saving measure for the MEO, but is not treated as such. By not including the cost factor for insurance since it will never be a realized cost, the MEO estimate can be decreased by \$346,602 to a figure of \$26,563,368 (\$26,909,970 - \$346,602) and reduced cost savings of \$6,083,774 (\$6,430,376 - \$346,602). By factoring in these other relevant costs, it still remains that the Air Force did save funds over their estimated MEO cost estimate, but certainly not to the degree initially projected.

B. ANALYSIS OF CONTRACT ARRANGEMENT

1. Introduction

To analyze the contract arrangement, we will examine the types of contract risk and how to determine contract risk that were set forth in Section C of Chapter II and apply them to the supply contract.

2. Types of Risk

a. Strategic Risks

Strategic risks are associated with the decision of whether or not to outsource a function. The three specific risks we will analyze are the outsourcing of core competencies, loss of flexibility, and opportunistic behavior.

(1) Outsourcing of Core Competencies. The DoD Senior Executive Council defines a military core competency as “a complex harmonization of individual technologies and production skills that create unique military capabilities valued by the force employing [commander in chief]”¹⁹². According to the Council, a core competency has potential application to a wide variety of national security needs, provides a significant contribution to the combatant commander's desired effect, would

¹⁹² United States General Accounting Office, and United States. Dept. of Defense. Defense Management: DOD Faces Challenges Implementing its Core Competency Approach and A-76 Competitions. Washington, D.C: U.S. General Accounting Office, 2003.

be difficult for competitors to imitate, provides the means to differentiate from competitors, crosses organizational boundaries within an enterprise, is a direct contributor to the perceived value of the service, does not diminish with use, deploys with forces, and provides training and experience that forms the basis of ethos and culture¹⁹³.

Based upon this definition, we would not consider the supply function to be a core competency of the military. Similar supply functions are carried out by every large organization, thus keeping it from being a unique military capability. In addition, the supply function is easily imitated by competitors, does not provide the means to differentiate from competitors, and is not a direct contributor to the perceived value of the service. Since the supply function is not a core competency, it is an appropriate function to outsource.

(2) Loss of Flexibility. The base commander certainly lost flexibility when the base outsourced its supply function. Instead of military and government civilian workers who could be directly supervised and directed, the function is now performed by contractor employees. These employees are supervised by the contractor and do not interact directly with government leadership. Instead, government leadership communicates to the contracting officer who, in turn, communicates with the contractor's management team. Any communications between the contractor's management team and their employees is at the discretion of the contractor. In addition, the contractor is only bound to perform the work listed in the contract. Any changes need to be negotiated with the contractor through the contracting officer. This not only requires time to perform, but can also increase cost if the contractor can reasonably claim that they will incur additional expenses to incorporate the changes.

This roundabout communication and the loss of direct supervision over the employees performing the work adds extra layers of bureaucracy and slows down the decision making process. However, the supply function is a relatively steady function and does not have a lot of variability. The only major changes in the day-to-day

¹⁹³ United States General Accounting Office, and United States. Dept. of Defense. Defense Management: DOD Faces Challenges Implementing its Core Competency Approach and A-76 Competitions. Washington, D.C: U.S. General Accounting Office, 2003.

operations would occur under a contingency operation. As long as contingency operations are addressed in the contract, the loss of flexibility should not have a substantial impact on the base supply operations.

(3) **Opportunistic Behavior.** The chances for opportunistic behavior are relatively low for this contract. There are numerous other companies that could perform the required functions. Furthermore, the contract is just over four years in duration with options every year. This means that the contractor knows that they will have to perform well or the contract will not be renewed and another contractor will take their place.

b. Operational Risks

Operational risks are not associated with the decision of whether to outsource a function, but rather the decision of *how* the function will be outsourced¹⁹⁴.

(1) **Packaging of Requirements.** The leadership at the Air Force Base decided to outsource the entire supply function into one contract. This seems to be a good packaging of requirements. Combining multiple bases that are not collocated with one another seems to be too broad of a scope for a single contract. At the same time, breaking the supply function apart into its sub-functions to be performed by multiple contractors would have led to higher coordination costs that would not have been worth the effort.

(2) **Insufficient SOW/PWS/QASP.** We were not able to review the QASP that was used for this contract and the contracting office chose to use a SOW in lieu of a PWS. Overall the SOW was well written and addressed the work that needed to be performed. It provided a good overview of the functions to be performed, provided a detailed break-down of all the tasks as well as historical data of the workload, provided minimum levels of service for each task, and addressed how the contractor must handle contingency operations.

¹⁹⁴ Chad M. Brooks, Edward J. White, and David E. Moore. Outsourcing Options to Meet Navy Recapitalization Goals. Naval Postgraduate School, 2004. Monterey, California.

However, there were two areas that could have been improved. The first is that there was not a sufficient penalty for not meeting the minimum level of service for a task. Since the contract was fixed price with no incentive fees, the penalty was the issuance of a Contractor Discrepancy Report (CDR) by the contracting officer. While CDR's are certainly a deterrent to poor performance, immediate fiscal penalties would probably have been more effective.

The second area for improvement was contingency operations. The paragraph addressing contingency operations was intentionally vague to allow flexibility for unknown possible future requirements. However, the pay structure was not very clear or adequate. In the description paragraph the SOW stated that any work performed for contingency operations would be included as part of the fixed price contract. This seems unreasonable since the cost of contingency operations could be very high and the contractor has no way to budget for it in their proposal. Instead, the contingency operations Contract Line Item Number (CLIN) should have been funded separately as cost-reimbursable. Then, in a later paragraph, the SOW stated that the contractor could submit their costs incurred under contingency operations for review and that the contracting officer could authorize reimbursement at their discretion. These seemingly contradictory statements create questions as to whether or not contingency operations would increase the cost of the contract.

(3) Quality and Type of Contract. As was stated in Chapter II, inappropriate or poorly written contracts can expose the agency to a high risk of interrupted service, poor quality, and cost growth¹⁹⁵. To minimize these risks, contracts should clearly state service levels and measurements, penalties for non-performance, growth and inflation rates, and termination provisions¹⁹⁶. If applicable, they should also address potential contingency situations to eliminate the costly and time-consuming contract modifications that would result if the contingency were to occur.

¹⁹⁵ Chad M. Brooks, Edward J. White, and David E. Moore. Outsourcing Options to Meet Navy Recapitalization Goals. Naval Postgraduate School, 2004. Monterey, California.

¹⁹⁶ Christopher Lonsdale. "Outsourcing: A Business Guide to Risk Management Tools and Techniques." March (1998).

The contract followed most of these suggestions. It clearly stated the required service levels and measurements, penalties for non-performance, termination provisions, and contingency situations. In addition, a fixed-price contract was used which is the preferred type for well-defined, routine, and recurring service.

The one area that was lacking was the growth and inflation rates. As can be seen in Table 5 in Chapter III, the contractor bid the same amount (\$3,575,999.22) in FY03, FY04, and FY05. This lack of anticipated cost growth certainly contributed to the contract not meeting the original cost projections.

(4) Length of Contract. The total contract duration was five years and two months. This included a two-month transition period, a base year, and four option years. This is a good length for a service contract because it keeps the contracting office from having to re-compete the contract every year or two and allows the contractor a chance to settle in and move along a learning curve. At the same time, it does not lock the base into too long of contract in which the contractor could exhibit opportunistic behavior. In addition, the inclusion of option years gives the base the flexibility to cancel the contract and re-compete the contract if they so desire. In theory this keeps the contractor from becoming complacent and letting quality and cost control decline.

(5) Insufficient Resources to Manage Contract. We do not have the data necessary to make a determination as to whether or not the base devoted enough resources to adequately manage this contract. However, based on the increased workload in the acquisition community mentioned in Section E of Chapter II and the problems with the contracts mentioned in Section F of Chapter II, we can make an educated deduction that there probably was not.

C. APPARENT STRENGTHS AND BENEFITS OF THIS A-76 COMPETITION

1. Short-Term Governmental Cost Savings

The first apparent benefit to the Air Force from an outsourced the supply squadron through this A-76 competition is the apparent cost savings. While cost savings occurred, as compared to the MEO, they were not as great in magnitude as desired. It is also apparent that as the contract progressed, cost savings diminished greatly over the

years. If this trend continues into the future, the Air Force will likely achieve increased costs over the long run outweighing the gains captured in the short-term putting increased stress on the discretionary portions of the Wing's overall budget.

2. Provides Incentive to Other Organizations to Cut Costs

By outsourcing the supply squadron through the A-76 process, there may have been the effect of opening the eyes of other non-inherently governmental positions to the danger of potentially being outsourced. With the fear of losing a job, or the decreased flexibility posed by non-contracted functions, units may be more aware of their costs. This increased awareness to the costs of an organization should motivate cost reductions in order to not be noticed for potential A-76 competition, and if competed, be more competitive in the process.

3. Active Duty Military Reassigned to Areas More Critical to National Defense

Due to military personnel remaining on active duty and being reassigned elsewhere after an outsourcing competition, national defense gains personnel that can be better utilized in more critical areas. Instead of having potential war fighting resources tied up dealing with a logistics tail, personnel are able to be moved into areas that are potentially short-manned, overstressed, and closer to the tip of the spear in responding to military contingencies. Overall, this provides more military manpower and options for combatant commanders.

D. APPARENT WEAKNESSES AND DEFICIENCIES OF THIS A-76 COMPETITION

1. Competition Done on "Best Cost" versus a "Best Value" Basis

The outsourcing process, as currently dictated by the A-76, simply looks at the costs of an organization versus what a contractor claims their costs will be to run the same operations. While this provides a simple approach to the idea of how to save government funds, it does not necessarily compare the intangibles brought by either source of labor. A contractor may specialize in supply chain management, which can provide them a distinct advantage over the government and gain significant efficiencies

because of it. On the other hand, a military or civilian employee with years of experience cannot be simply replaced with a new person and have a continued level of expertise in dealing with the bureaucracy of the federal government.

2. Poor Cost Estimates for the Contract to be Compared against the MEO

There are some areas of the A-76 competition itself that do not necessarily provide for comparisons of like costs. If both cost estimates are not treated in a similar manner, specifically in terms of the effects of inflation on wages, it distorts the two comparisons. Likewise, if a cost such as insurance for the government is artificial with no chance of ever actually being incurred, it should not be considered as a cost to the government. The ideal comparison of costs should be what is truly likely to be incurred by either party over the term of the performance.

3. Opportunity Costs Are Never Factored in the Competition

While difficult to quantify, opportunity costs are never factored into the process for the competition. Particularly, the source selection process is a tedious one by design in order to hopefully obtain a well written and fair contract; however, the time it takes to perform a proper source selection is time taken away from oversight of contracts already in place or meeting the immediate contracting needs for the base. This problem is further exacerbated if a contracting squadron is short-handed due to the current worldwide deployments of various military contracting personnel. Furthermore, increased contract costs over the years are required to be paid, which at times takes funding away from other priorities and projects of the base in order to ensure the contractor is paid. Many times, these other priorities and projects are delayed indefinitely, or when funded, cause a spike in workload on the personnel responsible for executing the project.

4. Loss of Flexibility to the Air Force

Outsourcing causes a loss of flexibility to the Air Force. With military personnel, a wing commander can simply ask, and likely get, military personnel to work overtime with no additional costs due to their salary nature. Government civilians may also be easily asked to work overtime and will likely oblige, albeit at a cost of time-and-a-half their pay rate or compensation time. Contractors, on the other hand, are not required to

work any more than what is dictated in the contract. If increased work is required and is not set forth in the contract, it will cause significantly higher costs to modify the contract in order to provide the necessary services.

5. No Method Available to Retract What Has Been Done if Long-Term Costs Become Unfavorable

Once an A-76 competition is complete, either the contractor or MEO basically become the standard. If there are increased costs in the future, it is very unlikely the government will be able to revert back to the status quo which existed prior to the A-76 competition. In other words, there doesn't appear to be a method to determine if it would be more cost beneficial to the government to change back to the way operations were run in the past.

6. Cost of Military Members Remaining on Active Duty Not Considered

The costs associated with military members remaining on active duty are not reflected within the data for the competition. From Chapter II, it is reasonable to estimate that military members are replaced by 0.6 civilian employees when considering the MEO portion of an A-76 competition. Meanwhile, the military members are reassigned to other areas of the military, in this case the Air Force, upon award of the competition to either the MEO or contractor. As an illustration, assume a unit of 100 military members is being studied for outsourcing. If this unit will be replaced by 60 civilians, the military members go elsewhere and the civilians run the operations of the unit. Costs overall will increase because there are now 160 total people on the roster of the government instead of the original 100 military. Similarly, if a contractor wins the competition with half of the manpower the MEO had, 30, there will be increased costs overall due to the increase in personnel to 130 people overall. Either way, as long as military members remain in the military upon an awarding of an A-76 competition, there will be overall increased costs.

7. A-76 Study Costs Savings May Be Better Suited for Units Entirely Composed of Civilians

Because of the issues with military member costs actually remaining on the books after outsourcing and the assumptions made in determining the number of civilians to fill

those positions, the A-76 competition process may be a better fit for organizations already comprised of 100% civilian workforce. In essence, this organization should be setup as an MEO already and will allow a more accurate and fair comparison to a contractor's proposal and give a better idea of true cost savings realized.

V. CONCLUSIONS AND RECOMMENDATIONS

A. CONCLUSIONS

While it appears from our analysis that the Air Force did save money from outsourcing the supply squadron as compared to the MEO in the A-76 competition, the magnitude of cost savings was never realized from those anticipated. In the comparison of historical data, analysis shows that the Air Force may have actually saved more money by having left the supply squadron to operate as it already was structured. This is especially true when military member costs are considered to still exist somewhere else in the Air Force. Flexibility to the Air Force is lost by going to a contractor operated unit and may also cause a significant strain on the Wing's budget as they cut other areas' funding throughout the base in order to pay the legally binding bill of a contract. Meanwhile, other operations or infrastructure of the base may deteriorate as a result of decreased necessary funding.

Conclusions found through the analysis of this particular Air Force supply squadron outsourcing process are highlighted against the previous findings of others as discussed in Chapter II in Table 14:

<u>Summary of Findings</u>	
<u>Strengths:</u>	<u>Relationship to findings covered in Chapter II:</u>
1. Short-term Governmental Cost Savings	"Risks of Outsourcing: Introduction," page 18
2. Provides incentive to other organizations to cut costs	"More Efficient and Better Performing Organizations," page 14
3. Active duty military reassigned to areas more critical to national defense	"Warfighting," page 13

<u>Weaknesses:</u>	<u>Relationship to findings covered in Chapter II:</u>
1. Competition done on “Best Cost” versus a “Best Value” Basis	“Lowest Cost Versus Best Value,” page 50
2. Poor Cost Estimates for the Contract to be compared against the MEO	“Poor Cost Estimates,” page 48
3. Opportunity Costs are never factored in the competition	“Risks of Outsourcing: Introduction,” page 18
4. Loss of flexibility to the Air Force	“Strategic Risks: Loss of Flexibility,” page 20
5. No method available to retract what has been done if long-term costs become unfavorable	“Strategic Risks: Opportunistic Behavior,” page 20
6. Cost of Military members remaining on active duty not considered	“Transfer of Costs,” Page 32
7. A-76 study costs savings may be better suited for units entirely composed of civilians	“Transfer of Costs,” Page 32

Table 14. Summary of Findings

B. RECOMMENDATIONS FOR BETTER COST ANALYSIS

Based upon the insights gained from the preceding analysis, it is recommended that comparable costs between the MEO and the contract proposal be based upon the real likelihood of their occurrence. In other words, costs that the government will in all likelihood incur should be included, such as future predicted wage increases for the personnel. On the other hand, since the government is self-insured, there should be no requirement for an insurance cost calculation because the self-insured nature can be seen

as an inherent benefit to maintaining government run operations. In terms of the contractor, since contracts are mandated by law to maintain equity in wages according to DOL wage determinations, future increases in wages should be estimated within the contract proposal's cost. The notion of a fair competition will be kept to a higher level of fairness by being realistic with costs which are likely be incurred over the period being studied rather than by setting somewhat arbitrary rules to provide an unrealistic sense of fairness.

C. RECOMMENDATIONS FOR BETTER CONTRACTING METHODS

Despite the fact that this contract was fixed-price and did not have a significant increase in workload, the cost of the contract increased 138%. This suggests that the use of equitable adjustments to cover increased contractor costs may have been too liberal. Contracting Officers awarding future contracts of this nature may want to use a fixed-price plus incentive fee or cost plus incentive fee contract to provide a stronger incentive for the contractor to control costs.

D. RECOMMENDATIONS FOR FURTHER STUDY

1. Further Analysis of Completed Competitions and Period of Performance

This is a study of only one particular A-76 competition. Similar analyses should be performed to determine if the same or similar conclusions can be drawn. In particular, for this study one supply squadron out of nearly all of the Air Force's supply restructuring was analyzed. Most supply operations within the Air Force are now conducted by contractors with the A-76 process having been the mode of setting them in place. These other outsourced operations should provide ample opportunity to be analyzed after-the-fact. Furthermore, operations other than the supply functions have been outsourced within the Air Force and should be available for analysis as well.

2. Feasibility of Centralized A-76 Competition Operations

Keeping in mind that each base is responsible for conducting its own competition, it may be a better process to have a team set up at a higher level responsible for conducting A-76 competitions. In particular, it is suggested that the feasibility of each major command (MAJCOM) having an office set up to directly deal with A-76

competitions for the various bases and units falling under their structure be studied. This more centralized process would allow personnel at each subordinate base to identify areas with potential to be outsourced and obtain the information to do the study. The MAJCOM can then do the analysis as a somewhat more disinterested party made up with individuals who deal solely and thereby specialize in A-76 competitions. These individuals would bring a steady stream of expertise to the process and ensure that competitions are accomplished in as fair and consistent of a manner as possible. Also, their continued presence with the A-76 process should be able to more clearly identify potential areas for improvement in the fairness of costing methods and overall process of accomplishing the competition.

VI. SOURCES OF INFORMATION

A. WHERE TO GET INFORMATION

In order to obtain the information to do an analysis similar to this one, there are four main offices to be contacted for raw data. The budget office of the Comptroller Squadron (office symbol CPTS/FMA) has all of the raw obligation data, historic and present, for each unit within a base. The Contracting Squadron (office symbol CONS) is the office which will have access to all of the contracting documents with their modifications. The Manpower Office of the Mission Support Squadron (office symbol MSS/MO) will have the information from the actual A-76 competition itself. Finally, the most recently released inflation factors for normalizing data to a constant year can be obtained through the office of the Deputy Assistant Secretary of the Air Force for Cost and Economics (office symbol SAF/FMC). All other information sources we cited are listed below.

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